APPENDIX 1

LLOYD’S NAMES UK GOVERNMENT GROUP LITIGATION

IN THE HIGH COURT OF JUSTICE **2002 folio 899**

QUEEN’S BENCH DIVISION

COMMERCIAL COURT

B E T W E E N :

FREDERICK THOMAS POOLE AND OTHERS

Claimants

– and –

HER MAJESTY’S TREASURY

Defendant

STATEMENT OF FACTS FOR FIRST TRIAL (THE ASF)

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1. **PREAMBLE**

1.1 This statement is prepared for the purpose of the first trial, dealing with the Grant of Rights and Limitation issues, ordered by Cresswell J on 31 March 2004. It sets out the facts on the basis of which those issues are to be determined. Where the parties have been unable to agree the relevance or content of an item, their rival contentions are set out.

2. **BACKGROUND TO THE CONDUCT OF INSURANCE BUSINESS AT LLOYD'S, GENERALLY AND IN THE PERIOD 1973 TO 1992**

2.1 **<u>The basic framework of the United Kingdom insurance market</u>**

2.1.1 Insurance business in the United Kingdom could be carried on by companies and other bodies authorised to do so by the DTI (later the Defendant), by friendly societies, by trade unions and employers' associations ….

2.1.2 Authorised insurance bodies may have been formed in the UK, elsewhere in the EU or outside the EU….

2.1.3. Lloyd's operated as an insurance market in which contracts of insurance were written through syndicates (see below) each consisting of members of Lloyd's. Historically, all those subscribing contracts at Lloyd's were individual underwriting members ("Names")…. Names operated through underwriting agents who had authority to manage or conduct insurance business on their behalf in dealing with brokers, the agents of the insured.

2.1.4. The way in which a Name put his wealth at risk at Lloyd's in providing insurance cover was as follows. He had to demonstrate that he possessed sufficient means, and sufficient capital appropriately invested (see below). The latter investments and the returns on them constituted reserve capital which was called upon only if, as a result of the underwriting carried out on his behalf, the premiums received from the insured (and any amounts derived from the reinsurance of the risks underwritten) did not cover claims from policyholders and other costs. The Name's liability was unlimited: if called upon to do so he was liable, if necessary, to sacrifice his entire personal fortune to pay valid claims, even if in total they went far beyond the amount of means originally declared. This was one of the two fundamental principles of membership of Lloyd's. The other was that Names underwrote on the basis of "each … for his/her own part and not for another". If a Name suffered a loss he could not call on other members to share it, nor could they call on him to share theirs. Likewise he was not called upon to share his profits. Occasionally, money was applied on a discretionary basis from the Central Fund to prevent or remedy default by Names….

2.1.5. ….

2.1.6. The Society of Lloyd's … had a range of functions in relation to the Lloyd's market and those carrying on business there….

2.1.7. ….

2.1.8. The UK corporate sector and the Lloyd's market each wrote insurance business outside as well as within the UK. A significant proportion of the losses complained of in these proceedings derive from business written at Lloyd's which directly or indirectly involved the insurance or reinsurance of risks originating in

the USA. A significant volume of business placed at Lloyd's emanated from other EU countries; as at 1994, a paper on Lloyd's prepared within Commission D-G XV put total insurance and reinsurance premium income from Europe at about 16%.

2.1.9. The entire UK insurance industry had for many years been subject to regulation pursuant to statute. Further detail – in relation to the position before and after the Insurance Directive -- is given below, but the broad position is as follows.

2.1.10. Successive public general Acts – principally the Assurance Companies Act 1909 ("ACA 1909"), Insurance Companies Act 1958, ICA 1974, ICA 1981, ICA 1982 and FSMA 2000 -- have made provision of general application to the carrying on of insurance business in the UK, but in some respects distinguishing between the corporate sector and the Lloyd's market. Subordinate legislation made under those Acts has followed a similar pattern. In addition, Lloyd's constitutive private Acts of Parliament – most recently LA 1982 – have contained provisions enabling the Society to exercise certain regulatory functions in relation to the Lloyd's market.

2.1.11. Before 5 January 1998, responsibility for the obligations imposed on the United Kingdom by the Insurance Directive lay with the Department of Trade and Industry (as variously named). From that date, responsibility passed to the Defendant. From 1 December 2001 the relevant functions were acquired by the FSA under FSMA 2000. Further details about these functions are set out in section 5 below.

2.2 **Governance and administrative structure of Lloyd's**

2.2.1 The Society of Lloyd's traces its origins to the 17th Century and was formally established by a deed of association in 1811. The Society had no separate legal personality until the Lloyd's Act 1871 united all persons admitted as members of Lloyd's before or after the passing of the Act into a body corporate known as Lloyd's, referred to as "the Society"…

2.2.2 Lloyd's Act 1911 …

2.2.3. At the beginning of the 1980's the statutory framework regulating Lloyd's was under review….

2.2.4. The constitution and operation of Lloyd's and its insurance market have been the subject of three inquiries and reports by committees chaired by eminent persons, namely Lord Cromer (1969), Sir Henry Fisher (1980) and Sir Patrick Neill (1987). There have also been numerous internal inquiries, reviews and disciplinary proceedings. The Cromer report (which was not published generally until 1986) was the precursor to a significant increase in the number of external Names …. The Fisher report was delivered in May 1980 and was the precursor to LA 1982.

2.2.5. By LA 1982 the constitution of the Society was refashioned and a new Council was created, equipped with wide powers to regulate the conduct of the practitioners in the market and to provide protection for the policyholders whose risks are insured and for the Names who underwrite those risks.

2.2.6. LA 1982 established a Council of Lloyd's to have control over the management and regulation of the affairs of the Society of Lloyd's (recital (6)(a)). The Council was to "have the management and superintendence of the affairs of the

Society and the power to regulate and direct the business of insurance at Lloyd's…" (Section 6(1)). The Council was empowered to make byelaws (subject to challenge at a general meeting) for the proper and better execution of the Society's statutory functions and for regulating the admission, suspension and disciplining of members of the Society, Lloyd's brokers, underwriting agents and others. The Council at first consisted of 16 working Names, 8 external Names … and 3 Names nominated by the other members of the Council and confirmed by the Governor of the Bank of England.

2.2.7. ….

2.2.8. ….

2.2.9. ….

Names

General

2.2.10 Names were not permitted to underwrite contracts of insurance otherwise than through an underwriting agent. Underwriting decisions were taken by one or more active underwriters employed by each syndicate's managing agent.

2.2.11 Underwriting members of Lloyd's could be categorised according to whether they were (or had been) substantially involved in the market as agents or brokers or their employees (the "working" Names) or, rather, had no such professional involvement in the market (the "external" Names)….

Admission to underwriting membership

2.2.12 In order to be eligible to underwrite insurance at Lloyd's an individual had to apply and be accepted as a member. The procedure applicable to admission to underwriting membership of Lloyd's was set out in the Manual for Underwriting Agents which was first published in 1971.

2.2.13 Taking a "1979 joiner" (i.e. a Name who first underwrites in the 1979 year of account) as an example, an application to become a Name and to commence underwriting on 1 January 1979 would normally be made during the course of 1978. Such an application could only be made through a registered members' agent (see below), who would provide the prospective member with the necessary forms and would guide him through the application procedure.

2.2.14 The members' agent was required to provide certain information to the prospective Name ….

2.2.15 The prospective Name would also receive a copy of the current Brochure and Lloyd's most recent global results (i.e. the aggregated accounts published by Lloyd's in or around September every year, known as "Aggregate Results" for the years down to and including 31 December 1981 and as "Globals" for subsequent years: see below)….

2.2.16 ….

2.2.17 In order to be eligible to commence underwriting on 1 January 1979, a prospective Name had to be at least 21 years old and be of suitable character and financial standing….

2.2.18 ….

2.2.19 The means requirements which an applicant was required to meet – sometimes known as the "show of wealth" -- differed depending upon the nationality and place of residence and domicile of the particular applicant. A candidate for working membership had to show lesser means than a candidate for external membership but this led to commensurately smaller premium income limits. The amount of business a Name was permitted to underwrite was circumscribed by the Name's means (including the level of resources placed at Lloyd's) and is referred to as an Overall Premium Limit. (The premium limit is based on a multiple of the membership means requirement). In order to determine financial standing, a UK citizen applying in 1978 to join Lloyd's as an external Name (i.e. a 1979 joiner) who was both a UK resident and domiciled in the UK would need to show a minimum level of means of £37,500 (permitting a maximum underwriting premium limit of £75,000 and requiring a minimum deposit of £20,000). A US national in 1978, wherever resident and domiciled, would need to show a minimum level of means of £100,000 (permitting a maximum underwriting premium limit of £150,000 and requiring a minimum deposit of £35,000). Satisfaction of the means requirement had to be shown in the form of a Statement of Means signed by an independent professional. The means requirement related to assets, not income.

2.2.20 If no objection was made to the Membership Department within one week, the Membership Department would prepare a request for the Lloyd's deposit to be provided, together with the relevant deeds, and would forward them to the members' agent for signing by the prospective Name. The request and deeds would be sent out by the end of November 1978….

2.2.21 ….

2.2.22 ….

2.2.23 Entrance fees and the Lloyd's deposit also were due to be paid at the latest by the end of November 1978. [*The Claimants say:* in practice they were often collected during the ensuing year.]

2.2.24 Membership requirements and procedures were reviewed annually as a matter of course by the Membership Department. In 1979 (i.e. in respect of 1980 joiners), the minimum means requirement for a UK citizen applying to join Lloyd's as a non-Lloyd's Name and who was also both a UK resident and domiciled in the UK was increased from £37,500 to £50,000. In 1983 (i.e. in respect of 1984 joiners), this requirement was increased again to £100,000. It remained at this level until at least 1988.

2.2.25 The list of qualifying assets which could be used by an applicant to show that he satisfied the minimum means test requirements referred to above was amended in 1982 (i.e. in respect of 1983 and subsequent joiners).At all relevant times, it was necessary for an applicant to show that at least 60% of the assets being used to

satisfy the means test were in a particular form. Prior to 1983 (i.e. for 1979 to 1982 joiners) these included "Bank Guarantees or Letters of Credit on any of an applicant's assets other than their own home". There was also a separate requirement prior to 1982 that the value of an applicant's own home (which was to be calculated at certified market value less any outstanding mortgage or loan and less £25,000 - increased to £50,000 in respect of 1981 and 1982 joiners) could not exceed 40% of the assets being used for the means test. These requirements changed in 1982, from which time onwards the applicant's own home was in itself no longer eligible as an asset at all. Conversely, it ceased to be excluded from the list of assets upon which a bank guarantee or letter of credit could permissibly be secured to meet the 60% requirement referred to above. [*The Claimants say*: that should strictly have resulted in an applicant's principal residence no longer being eligible to count towards the 40% means test requirement referred to above, but in practice many joiners during the 1980s based their entire show of wealth on the value of their principal residence.]

2.2.26 The prospective Name's membership of Lloyd's would commence on January 1st following when the Committee of Lloyd's had approved his membership and Lloyd's Membership Department had (or should have) received from the prospective Name or his Agent the entrance fee, the Lloyd's deposit, and the deeds referred to in paragraph 2.2.20 above duly executed by the prospective Name….

2.2.27 Joining Lloyd's had the following consequences for the Name:-

(a) The Name charged a range of assets to Lloyd's, which could be called on by Lloyd's without the Name's consent if he failed to comply with a request for funds made by his agent. The Name had to provide a bank (or, from the mid-1980s, an insurance company) guarantee or to provide security in the form of approved categories of assets to a specified level in order to support his underwriting.

(b) Where bank or insurance company guarantees were provided, the bank or insurer would require by way of cross security from the Name a charge over assets of the Name.

(c) The charges continued in being until the Name's resignation from Lloyd's became effective (see below). Hence, if the Name continued underwriting for the following year then these charging arrangements would be left intact.

(d) The Name assumed a liability to pay the entrance fee referred to above to Lloyd's and, for subsequent years, an underwriting subscription fee.

(e) [*The Defendant says:* The Name became liable to levies made by Lloyd's under the Central Fund Agreement and Byelaw (as described above)). (*The Claimants disagree* that this statement should appear here since any liability to pay a Central Fund levy was a consequence of a valid call by Lloyd's to do so, not a consequence of joining Lloyd's.]

(f) …. As a matter of convention, the Name was not asked for cash to cover the underwriting subscription fees and Central Fund levies referred to in (d) and (e) above or fees payable to agents. They were charged to his account with the agent and paid as they fell due, and in due course were

deducted from the profits the Name was paid when the account was settled. Like all other revenue and expenses arising from being in business they were accounted for over three years. [*The Claimants say* it is therefore incorrect to say the assets were reduced until the result of the accounting period is known]

2.2.28 Throughout the 1970s and 1980s the number of underwriting names increased year by year, peaking in 1989 as shown by the following figures:

year	Number of active Names	number of names	new joiners
1970		6,001	235
1976		8,565	2,251
1977		10,662	3,636
1978		14,134	3,325
1979		17,279	1,492
1980		18,552	880
1981		19,137	1,295
1982		20,145	1,754
1983		21,601	2,177
1984		23,436	2,949
1985	26,019	26,050	3,087
1986	28,242	28,944	2,827
1987	30,936	31,484	2,572
1988	32,433	33,532	951
1989	31,329	34,218	312
1990	28,770	34,146	251
1991	26,770	34,072	105
1992	22,259	32,802	67
1993	19,537	32,015	157
1994	17,624	31,789	63
1995	14,884	31,468	28
1996	12,960	31,132	62
1997	10,160	30,884	248
1998	7,263	21,864	276
1999	5,178	18,961	240
2000	4,167	16,375	91
2001	3,747	15,189	

The Names who were not active Names included those who had ceased underwriting but whose resignation had not yet taken effect (see below).

Matters arising during membership

2.2.29 A Name might vary his or her overall premium limit (i.e. the maximum underwriting premium limit referred to in paragraph 2.2.19 above) from year to year. Any increase would be reflected by a corresponding increase in deposit and required means….

Resignation

2.2.30 A person could resign from membership of Lloyd's with effect from a given underwriting year by giving notice 4 months before the end of the preceding underwriting year, but that notice did not take effect unless and until the last year of the last open syndicate in which he had participated had been closed (see below). A Name who had not given effective notice was thus committed to membership of Lloyd's for the following year as at 1st September A Name could not, however, be compelled to remain on any particular syndicate or indeed continue underwriting at all. The Member would simply become a "member not Underwriting"…. Upon ceasing to underwrite a Name remained a non-underwriting member until his Lloyd's affairs were wound up (ie until his last year of account was closed or his liabilities reinsured and all underwriting losses had been discharged). Until this occurred, the funds which the Name had lodged at Lloyd's were retained by the trustees ….

2.3 **Syndicates**

2.3.1 Each Lloyd's syndicate was an annual venture. The year during which it wrote business was described as an "underwriting year" or a "year of account" Prior to the end of the underwriting year the managing agent for the syndicate would indicate whether it proposed to continue with the syndicate in the next underwriting year, and if so it would invite syndicate members for the current underwriting year, possibly along with others, to apply for membership. The same syndicate number would continue to be used, but the participation in each year of account would or might differ, and the operations for each year of account were distinct commercial ventures. A Name would typically participate on more than one syndicate, and frequently on numerous syndicates.

2.3.2 Although a syndicate is an economic entity comprising the aggregate of the underwriting capacities allocated to it by its individual Names, it has no legal personality. In principle, a Name underwrites his/her own risk through a managing agent. The agent aggregates the underwriting capacity of individual Names for whom it is acting so that risks may be accepted. The grouping together of Names in this manner does not affect the legal position of individual Names vis a vis risk. Names trade on the basis of several liability and so are not responsible for the debts of other Names within the syndicate.

2.3.3 A Name joined a syndicate for a year of account when his managing agent added the Name's name to the Syndicate List for that year. Signing of lists normally took place in the last quarter of the previous year but occasionally, in individual cases, whether because of inefficiency or otherwise, syndicate participation was not finalised until after the start of the new underwriting year.

2.3.4 On joining a syndicate a Name would enter into an agreement with a members' agent. In the case of "direct" Names, the members' agent would also be the managing agent for the syndicate. In the case of "indirect" Names, there would be a series of matching pairs of Agreements, each pair consisting of (a) an agreement between the Name and his members' agent and (b) an agreement between the members' agent and the managing agent of each of the syndicates in which the Name participated. Until 1987 agents were permitted to use their own form of agreement. As from the 1987 year of account, standard forms were prescribed by Lloyd's from time to time for the Agreements used in respect of both direct and indirect Names.

2.3.5 When the Agreements were signed with members' agents, fees became payable to those Agents. The standard form of Agency Agreement in force as from the 1987 year of account provided (clause 3) that the date on which the Name was to be included as a member of each syndicate was the date specified in the "Syndicate Schedule". The Syndicate Schedule was a Schedule attached to the Agreement specifying each of the syndicates of which the Name was for the time being a member, and additional Schedules could be added from time to time by agreement between the Name and the agent (see definitions of "the Syndicate" and "the Syndicate Schedule")….

2.3.6 The Name would also agree with his member's agent at what level he wished to participate in each syndicate, i.e. his syndicate premium limit for that syndicate, and this would be reflected in the entry for the Name in the Syndicate List(s) for underwriting year in question.

2.3.7 As an underwriting year drew to an end, the Name had the option whether to cease underwriting at the beginning of the next year or to continue with the same syndicates and premium limits as before or to enter into fresh arrangements involving different syndicates and different limits. Subject to inefficiency or unusual circumstances, those arrangements would be concluded before the beginning of the new underwriting year. The Name was entitled to terminate his agreement with the members' or managing agent, referred to in paragraph 2.3.4 above, by notice in writing by 31 August (or any later date which the agent might in any particular case permit). By signing, or by not giving due notice to terminate, an Agreement the Name authorised the Agent(s) to conduct insurance business on his behalf (through underwriting contracts of insurance, reinsurance and/or reinsurances to close) in the following year of account ….

2.3.8 The underwriting capacity of a syndicate was known as its "stamp capacity", the aggregate of the syndicate premium limits of all the members for a given year of account of the syndicate.

2.3.9 A typical risk would be placed with a number of syndicates, or with syndicates and companies, with one particular underwriter (the "leader") setting the premium rate, approving the policy wording and, frequently, underwriting the largest "line" - or percentage - of the risk. Other underwriters would "follow".

2.3.10 The business of Lloyd's was traditionally divided into four principal categories: marine, non-marine, aviation and motor. Managing agents often described the syndicates they managed by reference to the main category in which they had traditionally operated. However, these descriptions were not comprehensive and did not define syndicates, which frequently wrote a broader range of business than those titles might suggest. Marine syndicates wrote, in some cases, an incidental non-marine account…. Some of these incidental non-marine accounts carried an excessive exposure to long-tail asbestos-related liabilities. Asbestos claims also fell on non-marine syndicates specialising in US casualty business. Asbestos claims arising from the shipbuilding industry and from the operation and maintenance of ships have also been made on marine policies. Asbestos-related claims were made on some aviation syndicates.

2.3.11 Each syndicate wrote a different mix of business, with each category of business carrying different risks. There was an important distinction between "short-tail"

and "long-tail" risks. The term "short-tail" was applied to business on which claims generally arose and were settled relatively soon after the risk was accepted and the premium paid; "long-tail" denoted business for which the notification or the settlement of claims, or both, might take many years.

2.3.12 ….

2.4 **Insurance and reinsurance business**

2.4.1 Lloyd's syndicates underwrote both "direct business" (where the policyholder had a direct interest in the underlying risk insured) and "reinsurance" (where the policyholder was an insurance company or another Lloyd's syndicate). Reinsurance could be of an individual risk (a facultative reinsurance) or a portfolio or specified part of risks previously written or yet to be written (treaty reinsurance). Some syndicates wrote retrocession (i.e. reinsurance of reinsurance) as well as reinsurance business. Many syndicates have written a mix of both direct insurance business and reinsurance business in a year of account.

2.4.2 One category of reinsurance written at Lloyd’s, in particular during the 1980s, was XL (“excess of loss”) and LMX (“London market excess of loss”) business. Under an XL reinsurance contract, the reinsurer agreed to indemnify the reinsured in the event of the latter sustaining a loss in excess of a pre-determined figure, (the deductible). The reinsurer was liable for the amount of the loss in excess of the deductible up to an agreed amount, the deductible being the amount retained, (or retention), for the reinsured's own account (or that of any underlying excess of loss reinsurers). The purpose of excess of loss reinsurance was thus to limit the exposure of the reinsured on any loss, whether this arose from a large individual risk or through an aggregation of losses from a number of risks affected by a single event or loss occurrence. In providing cover to primary insurers, accepting reinsurers might themselves accumulate exposures higher than they wished to retain. To meet their requirements for protection, the retrocession of excess of loss reinsurance developed as a mechanism that was intended to spread exposures more widely.

2.4.3 LMX is XL reinsurance written by London market entities. It was written by both corporate reinsurers and Lloyd's syndicates. The nature of LMX business was the same as that of other excess of loss treaty reinsurance. LMX business was distinguished from other excess of loss business in that it was, depending on usage, (i) reinsurance underwritten by underwriters operating in the London market of risks originating in this same market, as opposed to general excess of loss business that is reinsured on a worldwide basis, or (ii) an excess of loss reinsurance written in London of an excess of loss contract.

Lloyd’s three-year accounting system

2.4.4 According to the practice at Lloyd’s, every year of account of a syndicate was kept open for not less than three years from the beginning of that year of account. At the end of three years, a year of account was normally (but need not be) closed into the syndicate’s next year of account, by means of a contract known as Reinsurance to Close (“RITC”).

2.4.5 If a decision was taken not to close the relevant year of account, the account was described as having gone into "run-off" and no RITC premium was payable. Until

expiry of the three calendar year accounting period the relevant year of account would not be (and could not be) closed, and accordingly the relevant year of account would be described as “naturally open”. If a syndicate year was not closed by RITC at the end of the three calendar year period, that year was described as having been "left open". It was also said to be “in run-off”. No further business could be underwritten to a year that was in run-off i.e. had been left open.

2.4.6 A typical timetable, relating the three-year accounting system to a Name’s syndicate membership arrangements, would be as follows (taking a Name who first writes syndicate business on the 1978 year of account, and omitting many of the steps associated with the regulatory system associated with RITC – as to which see further below):

1978 Name writes business on 1978 year of account.

c. May/June: managing agent signs syndicate accounts closing 1975 into 1976 as at 31 December 1977. (By virtue of the three year accounting system, 1975 would include all prior years’ liabilities that had been reinsured by RITC and would hence commonly be referred to as “1975 and prior”.)

c. September: Lloyd’s Aggregate Results for 1977 published based on audited syndicate accounts as at 31 December 1977 (i.e. showing performance on the 1975 year of account).

c. October: Name’s name is added to syndicate list for 1979 year.

1979 Name writes business on 1979 year of account;

c. May/June: managing agent signs syndicate accounts closing 1976 into 1977 as at 31 December 1978.

c. September: Lloyd’s Aggregate Results for 1978 published based on audited syndicate accounts as at 31 December 1978 (i.e. showing performance on the 1976 year of account).

c. October: Name’s name is added to syndicate list for 1980 year;

1978 year of account remains open (and is now in its second year)

1980 Name writes business on 1980 year of account;

c. May/June: managing agent signs syndicate accounts closing 1977 into 1978 as at 31 December 1979.

c. September: Lloyd’s Aggregate Results for 1979 published based on audited syndicate accounts as at 31 December 1979 (i.e. showing performance on the 1977 year of account).

c. October: Name’s name is added to syndicate list for 1981 year.

1978 year of account (in its third year) and 1979 year of account (in its second year) remain open.

1981 Name writes business on 1981 year of account;

c. May/June: managing agent signs syndicate accounts closing 1978 into 1979 as at 31 December 1980. Name receives share of

underwriting profits for the 1978 year or cash call to contribute to share of underwriting losses;

c. September: Lloyd's Aggregate Results for 1980 published based on audited syndicate accounts as at 31 December 1980 (i.e. showing performance on the 1978 year of account).

c. October: Name's name is added to syndicate list for 1982 year;

1979 and 1980 years of account remain open.

1982 Name writes business on 1982 year of account;

c. May/June: managing agent signs syndicate accounts closing 1979 into 1980 as at 31 December 1981. Name receives share of underwriting profits for the 1979 year or cash call to contribute to share of underwriting losses;

c. September: Lloyd's Aggregate Results for 1981 published based on audited syndicate accounts as at 31 December 1981 (i.e. showing performance on the 1979 year of account);

c. October: Name's name is added to syndicate list for 1983 year;

1980 and 1981 years of account remain open.

Whilst a share of underwriting profits would be received only when the year in question was closed, a cash call could [*the Claimants say* exceptionally; *the Defendant says* not infrequently] be made at an earlier stage. This might reflect unprofitability of the underwriting, or it might reflect merely cash flow and be adjusted later on. [*The Claimants say:* in practice, if a cash call was made, it would usually be presented to Names as made for cash flow purposes, to be adjusted later on. From 1990 cash call statements were required to be accompanied by a report of the syndicate auditor to the effect that in the auditor's opinion the statement complied with the current "Cash Call Statement (Content and Form) Requirements" made by the Council.] [*The Defendant says:* agents had to be kept in funds to pay liabilities. To that extent calls could be considered to have been made for cash flow purposes. Otherwise, the Claimants' contention as regards the manner in which cash calls were presented is not accepted.] Once a year of account was closed, that year of account's profit or loss determined as a result of closure would be definitive.

RITC

2.4.7 RITC was an agreement pursuant to which underwriting Names of a syndicate for a given year of account ("the closed year") agreed with the underwriting members comprising that or another syndicate for a later year of account ("the reinsuring Names") that the reinsuring Names would indemnify the reinsured (or "cedant") Names against all known and unknown liabilities of the reinsured Names arising out of insurance business underwritten through that syndicate and allocated to the closed year, in consideration of:-

(a) a premium; and

(b) the assignment to the reinsuring Names of all the rights of the cedant Names arising out of or in connection with that insurance business (including without limitation the right to receive all future premiums,

recoveries and other monies receivable in connection with that insurance business).

2.4.8 The liabilities of a syndicate included at any given time liabilities which had been incurred but not yet reported ("IBNR"). (The term IBNR generally covered not only claims that were incurred but not reported but also the adverse deviation on known claims.) The provision for RITC was not adjusted for future investment income on the premium paid, and this provided a degree of additional, implicit protection against the risk that claims might exceed estimated claims.

2.4.9 The undischarged liabilities ceded by RITC included liabilities in respect of RITC of any preceding year of account. Liabilities were reinsured~~,~~ without limit in time or amount. When RITC was underwritten by the same syndicate, the premium was set by the managing agent of the syndicate, in conjunction with the underwriter, acting for the Names on both years of account.

2.4.10 Schedule 3 of the Syndicate Accounting Byelaw (No. 11 of 1987), which set out "Fundamental Principles and Statements of Accounting Policies", provided that:-

> "The accounting policies in respect of items which affect more than one year of account shall be such as to ensure a treatment which is equitable as between the members of the syndicate affected; and in particular the amount charged by way of premium in respect of reinsurance to close shall, where the reinsuring members and the reinsured members are members of the same syndicate for different years of account, be equitable as between them, having regard to the nature and amount of the liabilities reinsured."

2.4.11 This principle also appeared in Schedule 3 of the predecessor byelaw, No. 7 of 1984, and reflected previous proper practice. For details of the legislative framework governing the process see below.

2.4.12 RITC premium into a subsequent year of the same syndicate was not treated as premium income for the purposes of premium income monitoring (i.e. it did not count against a Name's premium income limit). The Syndicate Premium Income Byelaw (No 6 of 1984) dealt with circumstances in which RITC by a different syndicate would form part of premium income for premium income monitoring purposes.

2.5 **Premiums, reserving and claims**

2.5.1 All premiums received at Lloyd's were allocated to an accounts code for the purpose of monitoring income. [*The Claimants say* no distinction was drawn between direct and reinsurance business within a code.]

2.5.2 Determining an appropriate amount for reserves against IBNR claims was a central part of the RITC exercise. In effect the RITC premium paid to the reinsuring Names represented the reserve fund available to those Names from which to meet the IBNR liability they assumed from the cedant Names. The requirements and practice in relation to reserving are considered further in the description of domestic law, regulations and administrative practice in section 5.3 below….

2.5.3 ….

2.5.4 Where a claim was made on a policy written by a year of account which had been closed by RITC, the claim was treated for administrative purposes as if it were a claim on the reinsuring year of account which had written the RITC. This could work through a number of successive RITCs….

3. REGULATION OF UK INSURANCE BUSINESS BEFORE THE INSURANCE DIRECTIVE

3.1 Generally

3.1.1 The governing statute was the Insurance Companies Act 1958 as amended by Part II of the Companies Act 1967….

3.1.2 In addition to these provisions, as from 1 January 1973 the United Kingdom was required to act in accordance with Council Directive 64/225/EEC of 25 February 1964 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of reinsurance and retrocession.

3.2 Lloyd's

3.2.1 The provision as to Lloyd's itself (i.e. the Society of Lloyd's incorporated by Lloyd's Act 1871) under the 1958 and 1967 Acts may be summarised as follows:-

3.2.1.1 By Section 6 of the 1958 Act the Committee of Lloyd's was required to deposit every year with the Board of Trade a statement in prescribed form summarising the extent and character of the insurance business done by the members of Lloyd's in the 12 months to which the statement related. In this regard the Assurance Companies Rules 1950 (SI 1950 No. 533), originally made under the ACA 1909, required Lloyd's each year to submit to the Board of Trade an overall statement for combined operations as to all the members of Lloyd's separately identifying the position for each of the three open years in respect of four classes of business.

3.2.1.2 By Section 10 of the 1958 Act the Board of Trade was to lay annually before Parliament documents deposited with them during the preceding year (including the statement by the Committee of Lloyd's) and might append any note of the Board thereon and any correspondence in relation thereto.

3.2.1.3 The 1967 Act repealed Section 10 of the 1958 Act. In its place, a more limited obligation was imposed by Section 98 of the 1967 Act requiring the Board of Trade to cause a General Annual Report of relevant matters to be laid before Parliament.

3.2.2 The position as to members of Lloyd's under the 1958 and 1967 Acts was as follows:-

3.2.2.1. By Section 2 of the 1958 Act only certain types of company could carry on insurance business of specified classes. However, by Section 1(6) the 1958 Act did not apply to members of Lloyd's, provided that requirements in the First Schedule to that Act were met.

3.2.2.2. A first such requirement was that every underwriter must, in accordance with the trust deed approved by the Board of Trade, carry to a trust fund all premiums received by him or on his behalf in respect of any insurance business.

3.2.2.3. A second requirement was that the accounts of every member must be audited annually by an accountant approved by the Committee of Lloyd's and the auditor must furnish a certificate in prescribed form to the Committee and to the Board of Trade. The certificate must state whether in the opinion of the auditor the value of the assets available to meet the members' liabilities in respect of the insurance business is correctly shown in the accounts, and whether or not that value was sufficient to meet the liabilities calculated on a basis approved by the Board of Trade.

3.2.2.4. A third requirement was that the member must, when required by the Committee of Lloyd's, furnish such information as might be required for the purpose of preparing the statement of business which was to be deposited with the Board of Trade under Section 6 of the 1958 Act.

3.2.2.5. ….

3.2.3 ….

3.3 **<u>The 1973 and 1974 Acts</u>**

3.3.1 Proposals for reform of legislation concerning UK regulation of insurance took statutory form when the Insurance Companies Amendment Act 1973 (1973 c.58) received the Royal Assent on 25 July 1973, the day after the making of Directive 73/239.

3.3.2 The legislation down to the 1973 Act was then consolidated in the ICA 1974, whose provisions governed the regulation of the insurance industry in Great Britain as at the original due date prescribed by the Insurance Directive (27 July 1976). The categories of persons permitted to carry on insurance business in Great Britain were listed in s. 2 ICA 1974. The Secretary of State's powers of control over insurance companies, including powers of intervention, imposition of restrictions on new business and investment, and limitations on premium income, were set out in Part II. S. 12(4) exempted members of Lloyd's from Part II so long as they complied with s. 73, which in turn engaged sections 74 and 75, the material requirements of which as at the due date were as follows.

3.3.3 The accounts of each Lloyd's Name were required by statute to be audited annually by an accountant approved by the Committee of Lloyd's (ICA 1974 section 73(4)-(5)). These provisions required the auditor to furnish a Statutory Audit Certificate, in a prescribed form, to both the Committee of Lloyd's and to the Secretary of State for Trade. The Certificate was required to state whether in the opinion of the auditor the value of the assets available to meet the underwriter's liabilities in respect of insurance business was correctly shown in the accounts, and whether or not that value was sufficient to meet the liabilities calculated:-

(a) in the case of liabilities in respect of long term business, by an actuary; and

(b) in the case of other liabilities, by the auditor on a basis approved by the Secretary of State (or, from 24 December 1996, the Defendant)

3.3.4 During the period to July 1976 the form of certificate was prescribed by the Assurance Companies Rules 1950, r. 16….

3.3.5 The basis on which liabilities were required to be calculated was set out in the Audit Instructions, approved by the Secretary of State and issued by Lloyd's each year.

3.3.6 Each Name was required, in accordance with the provisions of a trust deed approved by the Secretary of State, to carry to a trust fund all premiums received by him or on his behalf in respect of any insurance business (section 73(2) of the ICA 1974). (A separate fund was held in the USA -- the Lloyd's American Trust Fund -- for business done in US dollars, whether originating in the USA or not, and a similar arrangement existed in Canada).

3.3.7 The Committee of Lloyd's was required to deposit every year with the Secretary of State a "Statutory Statement of Business" in prescribed form summarising the extent and character of the insurance business done by the members of Lloyd's (section 74 of the ICA 1974). The Statement for a particular year could not be filed in proper form unless unqualified Statutory Audit Certificates had been received in respect of the insurance business done by each Name participating in one or more syndicates during that year.

3.3.8 Compliance with the statutory requirements outlined in the preceding paragraphs was a condition for the exemption of members of Lloyd's from certain of the provisions of the Acts regulating the business of insurance undertakings in general (ICA 1974 sections 12(4) and 73).

3.3.9 For all years of account, the Audit Instructions included instructions as to the quantification of reserves requiring reserves to be the greater of the following:-

(a) (in relation to most classes of business, including non-marine "all other") the result of the application of a specified multiple to the net premium income for the year of account, known as the minimum percentage reserves ("MPRs"). For the oldest year of account referred to in each year's Instructions, and all years previous to the oldest year of account, an alternative test of outstanding liabilities was to be applied if this would result in higher reserves;

(b) the total of the estimated outstanding liabilities on the relevant accounts as at the relevant date, which was required to include an element to take care of "unnoted and unknown liabilities" (including run-off costs); and

(c) the amount of the RITC for the closing year of account, including any previous years reinsured into that account (provided the year in question was not being run off).

4. LEGISLATIVE BACKGROUND TO THE INSURANCE DIRECTIVE

4.1 <u>Travaux préparatoires</u>

4.1.1 The EC Treaty included at the material time the following relevant provisions:-

"TITLE III

Free movement of persons, services and capital

…

CHAPTER 2

RIGHT OF ESTABLISHMENT

Article 52

Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be abolished by progressive stages in the course of the transitional period. Such progressive abolition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 58, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital.

Article 53

Members States shall not introduce any new restrictions on the right of establishment in their territories of nationals of other Member States, save as otherwise provided in this Treaty.

Article 54

1. Before the end of the first stage, the Council shall, acting unanimously on a proposal from the Commission and after consulting the Economic and Social Committee and the European Parliament, draw up a general programme for the abolition of existing restrictions on freedom of establishment within the Community. …

The programme shall set out the general conditions under which freedom of establishment is to be attained in the case of each type of activity and in particular the stages by which it is to be attained.

2. In order to implement this general programme … the Council shall, on a proposal from the Commission and after consulting the Economic and Social Committee and the European Parliament, issue directives ...

3. The Council and the Commission shall carry out the duties devolving upon them under the preceding provisions, in particular:

(a) by according, as a general rule, priority treatment to activities where freedom of establishment makes a particularly valuable contribution to the development of production and trade;

…

(c) by abolishing those administrative procedures and practices, whether resulting from national legislation or from agreements previously concluded between Member States, the maintenance of which would form an obstacle to freedom of establishment;

…

(f) by effecting the progressive abolition of restrictions on freedom of establishment in every branch of activity under consideration, both as regards the conditions for setting up agencies, branches or subsidiaries in the territory of a Member State and as regards the conditions governing the entry of personnel belonging to the main establishment into managerial or supervisory posts in such agencies, branches or subsidiaries;

(g) by co-ordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 58 with a view to making such safeguards equivalent throughout the Community;

(h) by satisfying themselves that the conditions of establishment are not distorted by aids granted by Member States.

Article 57

1. In order to make it easier for persons to take up and pursue activities as self-employed persons, the Council shall, on a proposal from the Commission and after consulting the European Parliament, … issue directives for the mutual recognition of diplomas, certificates and other evidence of formal qualifications.

2. For the same purpose, the Council shall, before the end of the transitional period, acting on a proposal from the Commission and after consulting the European Parliament, issue directives for the co-ordination of the provisions laid down by law, regulation or administrative action in Member States concerning the taking up and pursuit of activities as self-employed persons.

Article 58

Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

“Companies or firms” means companies or firms constituted under civil or commercial law, including co-operative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.”

Chapter 3 ("Services") Articles 59 to 63 contained broadly corresponding provisions, as regards freedom to provide services, to those set out in Articles 52-54 above. Article 61.2 provided that the liberali~~z~~sation of banking and insurance services connected with movements of capital shall be effected in step with the progressive liberalisation of movement of capital. Article 66 provided that the provisions of Articles 55 to 58 shall apply to the matters covered by Chapter 3.

4.1.2 Pursuant to Article 54 of the EC Treaty the Council issued on 18 December 1961 the General Programme for the Elimination of Restrictions on Freedom of Establishment (JO No 36/62 of 15 January 1962).

4.1.3 ….-

4.1.4 Title III of the General Programme listed the types of restrictions required to be lifted according to the time-table set out in Title IV. Title IV of the General Programme set out a time-table, on a sector by sector basis, for the effective elimination of restrictions on the freedom of establishment. In that context, Title IV.C stipulated the time-table for the removal of such restrictions for undertakings engaged in the provision of a list of activities, including:-

> "direct insurance firms, excepting life-assurance. However, the raising of restrictions on the creation of agencies or subsidiaries is subject to a coordination of the conditions of access and exercise."

4.1.5 Title VI, which is entitled "Coordination of guarantees required of companies [and firms] provided as follows:

> "The coordination of guarantees that are demanded of companies [*The Claimants say:* and firms] in Member States to protect the interests of both [associates] [members] and third parties, insofar as this is necessary and with a view to establishing their equivalence, is envisaged before the end of the second year of the second stage of the transition period.

In the French version, which is the original, the words "to protect the interests of both associates and third parties" read as follows: "*pour protéger les interêts tant des associés que des tiers*".

4.1.6 On 17 June 1966 the Commission presented to the Council a proposal for a first Council Directive on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance (JO 1966 No 3056/66 of 3 October 1966). The preamble recited inter alia as follows:-

> "Whereas by virtue of the General Programme the removal of restrictions on the establishment of agencies and branches is, in the case of the direct insurance business, dependent on the coordination of the conditions for the taking-up and pursuit of this business; whereas such coordination should be effected in the first place in respect of direct insurance other than life assurance;
>
> "Whereas in order to facilitate the taking-up and pursuit of the business of insurance, it is essential to eliminate certain divergencies which exist between the six national bodies of supervisory legislation; whereas in order to achieve this objective, and at the same time ensure adequate protection for insured and third parties in all the Member States, it is

desirable to coordinate, in particular, the provisions relating to the financial guarantees required of insurance undertakings;
"Whereas a classification of risks in the different classes of insurance is necessary in order to determine, in particular, the activities which are subject to a compulsory authorisation and the amount of the minimum guarantee fund fixed for the class of insurance concerned;
"Whereas it is desirable to exclude from the application of this Directive mutual associations which, by virtue of their legal status, fulfil appropriate conditions as to security and financial guarantees; whereas it is further desirable to exclude certain institutions in several Member States whose business covers a very limited sector only and is restricted by law to a specified territory or to specified persons;;
…
"Whereas the search for a common method of calculating technical reserves is at present the subject of studies at the international level; whereas it therefore appears to be desirable to reserve it to later Directives to achieve coordination in this matter, as well as questions relating to the determination of categories of investments and the valuation of assets;;
"Whereas it is necessary that insurance undertakings should possess, over and above technical reserves of sufficient amount to meet their underwriting liabilities, a supplementary reserve, to be known as the solvency margin, and represented by free assets, in order to provide against business fluctuations; whereas in order to ensure that the requirements imposed for such purposes are determined according to objective criteria, whereby undertakings of the same size are placed on an equal footing as regards competition, it is desirable to provide that such margin shall be related to the overall volume of business of the undertaking and be determined by reference to two indices of security, one based on premiums and the other on claims.
"Whereas it is desirable to require a minimum guarantee fund related to the size of the risk in the classes undertaken, in order to ensure that undertakings possess adequate resources when they are set up and that in the subsequent course of business the solvency margin shall in no event fall below a minimum of security;
…"

4.1.7 Title I of the proposed directive dealt with its scope. Title II established rules applicable to undertakings having their headquarters ("siege social") within the Community. That Title contained three sections. Section A dealt with conditions of access to the market. Section B dealt with conditions of exercise of freedom of establishment. It comprised Articles 13 to 21. Section C dealt with withdrawal of authorization.

4.1.8 Within Title II, Article 13 provided that Member States should collaborate closely with one another in supervising the financial position of authorized undertakings. Articles 14, 15.1 and 15.2 provided as follows:-

"*Article 14*
The controlling authority of the Member State on whose territory the company HQ of the firm is located should be kept informed by the controlling authorities of other Member States, so that the Member State

is able to verify the solvency status of this company in respect of all its activities.

"Article 15
1. Each Member State on whose territory a firm exercises its activity requires that the latter form technical reserves to cover contracted commitments on its territory.
The amount of these reserves is determined according to rules set by the State or, failing this, according to practices established in that State.
2. The technical reserves should be represented by congruent, equivalent assets located in each country of operation. However, dispensations to these rules on the congruence and localisation of assets may be granted by Member States.
Such assets should belong to the investment categories admitted by the regulations in the country of operation and be assessed according to the rules set by that country.
…"

4.1.9 Article 16 provided, *inter alia,* that Each Member State should require every undertaking whose head office was situated in its territory to establish an adequate solvency margin in respect of its entire business. The solvency margin should correspond to the assets of the undertaking, free of all foreseeable liabilities, less any intangible items. Detailed provisions were set out for its calculation, using the "First result" and "Second result" based on premiums and claims respectively. By Article 17, one-third of the solvency margin was to constitute the guarantee fund; but the guarantee fund was not to be less than the amount specified in relation to corresponding types of business. Those amounts at that stage ranged from 200,000 to 500,000 units of account. Articles 20.2 and 22.1 made provision for the competent controlling authorities to take, in specified circumstances, all measures to safeguard the interests of insured parties.

4.1.10 Within the Economic and Social Committee, a complementary report on the Commission proposal dated 13 March 1967 was prepared by the specialised section for non-salaried activities and services. The Section's General Observations included the following:-

> "Freedom of establishment, in the strict sense of those words, does not give satisfaction in practical terms while different regulations exist in the various member states concerning the conditions governing access and exercise. In the insurance sector, establishment requires an administrative approval, and its acquisition is subject to several conditions (legal, financial, accounts-related, technical and economic). It is clear, moreover, that those conditions sometimes differ as regards both national companies and foreign companies.
>
> Consequently, it has been found difficult to realise freedom of establishment without having previously established the equivalence of conditions of access. That is why it is stipulated in section IV C of the General Programme for the Elimination of Restrictions on the Freedom of Establishment that the coordination of the conditions of access to direct insurance activities and the exercise of those activities must be realised before the restrictions on the creation of agencies or branches are eliminated."

4.1.11 On 26 April 1967 the Economic and Social Committee delivered its Opinion on the Commission's Proposal (JO No 158/2 of 18 July 1967). The Committee observed in the preamble to this Opinion the following points:-

> "considering that the directive should allow an initial step to be taken on the road towards coordinating access to the activity of direct insurance (other than life assurance) and its exercise in the Common Market, and considering that, in particular, freedom of establishment turns out to be inadequate in practice, when national legislative provisions regulating conditions of access and exercise differ, as is the case in the area of insurance,
> "considering that there is currently no single market in this area, in that the legal, fiscal and monetary conditions for the development of such a market are not yet in place,
> "considering that, in the interest of progressive integration, this directive is deemed necessary, also for reasons of an economic nature,
> "considering that it consciously refrains from proposing concrete principles respecting the area of insurance,"

4.1.12 Turning to the principles of the proposed Directive, the Economic and Social Committee commented as follows:-

> "The Committee has initially studied the problems posed by the coordination of provisions concerning direct insurance. It has judged that the problems need to be examined with special attention, as they may also have consequences of a social nature for the structure of firms, for workers in the insurance sector and also, in particular, for insured parties.
> The Committee judged unanimously that the directive should comprise a general regulation encompassing all companies for direct insurance (other than life assurance) with their headquarters within the EEC, even if, in certain Member States, the implementation of the directive has the effect of exacerbating currently valid provisions in the area of insurance controls.
> On the other hand, differences of opinion have emerged regarding a general application of articles 16 and 17 that treat financial requirements.
> The criterion proposed by the Commission for setting the solvency margin is based on a given degree of security. As for the insured, he is concerned that the degree of security should be very high but also desires that his insurance can be obtained for less and less cost.
> Hence, a compromise must be found between these two opposing demands, indicating that the margin proposed by the Commission should be re-examined by considering it in its entirety.
> In opposition to the proposals aiming to eliminate difficulties resulting from the financial load envisaged in articles 16 and 17 by exempting certain firms from the application of these provisions when their activity is limited to the territory of the State on which they have their headquarters or when their volume of business is modest, and also by opposing the proposals aimed at resolving the problem by a general lowering of rates achieved by accessing new bases of mathematical calculation, the Committee has reached the conclusions cited below:
> - the Committee judges that the provisions of articles 16 and 17 can only be considered an indissoluble whole. Hence, the objections that it makes

to the present text of the proposal for a directive and the solution that it recommends refer to both articles;
- the robustness of a properly managed insurance firm rests, in particular, on sufficient technical reserves and on adequate property. The technical reserves are intended to cover the commitments of an insurance firm. The Committee has taken note of the fact that a coordination of the provisions respecting these reserves is currently not yet possible;
- articles 16 and 17 of the proposal for a directive regulate the requirements respecting company property, as follows: on the one hand, they set a minimum capital, determined in absolute figures (minimum guarantee fund) and, on the other hand, a sum fixed according to the volume of business (solvency margin);
- like the Commission, the Committee is of the opinion that the directive should, at Community level, set precise figures in respect of the property to be demanded;
- however, the Committee considers that the system proposed by the Commission in articles 16 and 17 is too schematic and does not take adequate account of the differences in structure between companies and of the very great difference in risks covered by the various insurance branches;
…
- furthermore, the Committee sees in articles 16 and 17 an automatic link between volumes of business and property that is too severe; this link would restrict companies to an economically unjustified limit on concluding new contracts or to an undesirable recourse to the money market;
- hence, the Committee deems that it is proper to differentiate the minimum guarantee fund according to branch and to adapt the amount according to the development of premium collection;
- in parallel to this guarantee fund, whose amount is determined in absolute figures, an additional requirement - taking into consideration the size of the company in each case - should be imposed, expressed as a percentage of the volume of business or of the burden of losses; a certain disparity is to be expected for large companies, given that a more significant portfolio implies greater balance."

4.1.13 The Economic and Social Committee commented on Articles 15 and 16 as follows:-

"*Article 15*
The Committee confirms that the constitution of technical reserves will still, for the time being, come under national legislations. Furthermore, there are also considerable disparities at the national level that can only be harmonized with great difficulty.
Given the impossibility of finalizing harmonized provisions in the calculation and the "representation" of various techniques, the Committee considers it especially important that the national control authorities ensure that insurance companies subjected to their supervision should possess adequate technical reserves.
(In the French text, "… *le Comité estime particulièrement important que les autorités de contrôle nationales vaillent à ce que les enterprises*

d'assurance soumises à leur surveillance disposent de réserves techniques suffisantes")

"Articles 16 and 17

…

B. From the point of view of the fund, the Committee cannot approve the draft proposed for articles 16 and 17, given the reasons expressed above. To avoid economically unacceptable situations for small and medium-sized companies, and also in the interests of protecting insured parties, it is necessary to modify the provisions for the constitution of the solvability margin and the guarantee fund. In doing this, particular account should also be taken, instead of the general regulations proposed, both of differences in the nature of insurance branches and of the volume of business of companies affected by the directive.

Regarding this problem, the Committee has not considered it justified to formulate technical proposals expressed in percentages just at present. Nevertheless, it wishes to highlight the trend of economic policy on which it considers the technical rules of articles 16 and 17 should be based.

In this regard, account should be taken of the following points that are especially important:

1. *Fixed part of property (guarantee fund)*

a) For companies whose premium receipts do not exceed a certain threshold, a reduction should be envisaged in the amount of the guarantee fund, possibly to 50%. However, the reduction in the guarantee fund should only be taken into consideration for companies already in existence. …

b) An increase in the guarantee fund may be envisaged for cases in which the volume of business exceeds certain thresholds. To be specific, it is important that the margin between successive thresholds be sufficient for the automatic link of articles 16 and 17 of the directive proposal to be avoided.

…

2. *Variable part of the company's property (solvency margin)*

…

Lastly, the Committee also deems it necessary to underline, in this context, that the period cited in article 29, paragraph 1, should be extended from three to five years. The fact that the insurance sector differs among the Member States makes this extension essential, given that, if this step is not taken, there is a risk of uneven development with all the disadvantages arising from it."

4.1.14 The last consultative step in the preparation of the Directive was the Opinion of the European Parliament (JO 1968 No C27/15). The Opinion stated amongst other things that the Parliament:-

"3. considers it desirable in articles 16 and 17 of the proposal of the Commission of the EEC, to replace the system of payable, own capital endowment based on the solvability margin and the minimum guarantee fund with a system based on a minimum guarantee fund and an additional fund with a variable amount;

4. renounces its proposal of defined rates for the guarantee fund and the variable element;

5. unanimously recognizes that the determining criterion for setting these rates should be the intention to protect insured parties, that is, the own capital endowment of an insurance firm should allow it, permanently and in every case, to execute the insurance contracts that it has concluded;
6. is, consequently, of the opinion that, in fact, the obligations imposed on insurance companies in respect of own capital endowments should not be greater or less than those proposed by the Commission of the European Economic Community;
7. considers, however, that it is desirable and justifiable to further reduce the amount of payable own capital endowments for small insurance firms, that is, for firms the products of whose collected premiums is less than 2.5 million units of account and whose contract portfolio is balanced and, in particular, to reduce the guarantee fund by 50%;"

The Parliament agreed with the Economic and Social Committee that the period within which existing undertakings must comply with the requirements of the Directive should be extended from three years to five.

4.1.15 The Working Group on Economic Matters within the Council of Ministers continued the first reading of the proposal and examined articles 8 to 15 of the proposal on 18 and 19 March 1969. An amendment was proposed to the end of the first sentence of the text of Article 14. The obligation of the supervisory authority of the Member State in whose territory the head office of the undertaking was situated had been limited by the Commission proposal which referred to the "opportunity of checking the solvency of that company for all its activities". The amendment proposed by this working group was to the effect that those supervisory authorities:

> "must verify the state of solvency of the undertaking with respect to its entire business"

This amendment subsequently appeared in the text of Article 14 which was adopted.

4.1.16 A Commission working document for the working group "*Assurances-dommages: droit de contrôle*" ("Loss Insurance: law of supervision") (XIV/542/71-F) referred to the General Programme of 1961 on the free provision of services, stating that it made the elimination of those restrictions in the sphere of insurance "subject to the following conditions (Section V, C(a)):-

> "- The realisation of freedom of establishment and the coordination of the law on the supervision of insurance to the extent necessary for the realisation of freedom of establishment, a period of two years being envisaged between the introduction of freedom of establishment and the introduction of free provision of services.
>
> …"

The document stated that that condition would be fulfilled as soon as the Council had promulgated the directives submitted on 2 February 1967 and 17 June 1966 (the latter being what became the Insurance Directive). The document also contained the following comments (under the heading "General orientation of operations"):-

> "Without prejudice to the special regulations in section V C (a), section VI of the general programme also envisages that "simultaneously with the preparation of the directives designed to implement the general programme for each category of service, it will examine whether the lifting of restrictions on the free provision of services should be preceded, accompanied or followed by the coordination of the legislative, regulatory or administrative provisions concerning those services".
>
> This examination is the subject of the present note. The extent to which those provisions need to be coordinated is estimated according to the necessities of the Common Market which must be established by virtue of the EEC Treaty (article 2). The various national markets must become a single market. It will also be necessary to set up conditions for insurance services that correspond to those of an internal market.
>
> To achieve that objective, firstly the restrictions on establishment and the free provision of services in insurance matters must be eliminated (article 2 (c)). Secondly, a system must be set up guaranteeing that competition between insurance companies within the Common Market is not distorted (article 3 (f)). The harmonisation of national legislations is envisaged where it is necessary for the operation of the Common Market in insurance matters (article 3 (h)).
>
> The Common Market in insurance matters cannot operate while provisions that differ from country to country distort competition and make access to the insurance business and its exercise in the Community more difficult, or lead to inadequate protection for insured parties and third-party beneficiaries."

4.1.17 In an internal note dated 28 March 1972, an individual Departmental Manager working for the Commission recorded a number of points relating to the proposed coordination directive following a 2-day meeting which a colleague had held with UK officials. The note included the following in relation to Lloyd's:-

> "There are a few problems regarding Lloyd's; regarding the solvency guarantees, as this considerably exceeds what is envisaged in the directive; a small adjustment would be necessary to enable Lloyd's to form an entity that could be taken into consideration in the various member states."

In a further note of 19 April 1972 following a meeting between Commission officials and an official from the UK Department of Trade and Industry, the following points were noted in relation to Lloyd's:-

> "Mr Steel [of the DTI] proposed that the following legal forms be admitted as regards the United Kingdom:
>
> …
>
> > "- a member of any association of underwriters approved by HMG (including Lloyd's);
>
> …
>
> "Regarding Lloyd's, it is clear that it will be necessary to take the existence of this very particular entity into account, but it seems that it will be difficult to accept the creation of other entities of the same nature in the future.

…

“c) Problems raised by applying the directive to Lloyd’s

“The United Kingdom agrees in principle that the directive should apply to Lloyd’s, but considers that certain articles should be adjusted to that effect as they are inapplicable as matters stand. Those articles are in particular:

…

11) … secondly there is the problem of the balance sheet and profit and loss account which Lloyd's does not have. It could be acceptable for Lloyd's to supply the accounts it submits to the British authority every year. The present text may have to be amended in this sense.

15) This article obliges the member states to impose the constitution of sufficient technical reserves. As regards Lloyd's, there are no technical reserves. Rather, each member of Lloyd's must have his accounts checked by an auditor who must declare that the assets are sufficient to enable him to honour his undertakings. This system can be considered satisfactory, but necessitates an adjustment of the directive.

16/17) The Lloyd's solvency system is very individual and articles 16 and 17 are clearly inapplicable to it. An alteration of those articles will be necessary to enable Lloyd's to maintain its system, which gives very satisfactory guarantees. Moreover, Lloyd's will have to be considered as a unit, although it is made up of a large number of insurers.

19) Regarding its accounts, the special nature of Lloyd's will have to be taken into account. Certain annual declarations are required at present. Perhaps this system can be maintained without altering the wording of article 19.

“In conclusion, it seems difficult to apply certain articles to Lloyd's without substantially altering the operation of that insurance exchange. Consequently, in view firstly of the economic importance of this insurance market and secondly of the guarantee it offers (thanks to the fund, and the insurance guarantee, the beneficiaries of indemnities have always been paid), it would be better to alter the directive to take its existence into account.”

4.1.18 Following consideration within the Council by the Committee of Permanent Representatives in its 652nd session of 19 July 1972, Member States were invited to present their observations. A Note dated 27 December 1972 (SEC (72) 4754) from the Commission’s Services considered the position taken by the Commission on the requests for consultation presented by the UK and Ireland on the draft directive. The Note includes the following points in relation to Lloyd’s:-

“A. Entities qualified to conduct insurance business

“1. Lloyd's

"The British position:
"Because of its well-known special characteristics, Lloyd's would in fact experience certain difficulties in complying with articles 8, 16 and 11 of the directive. Certain amendments are therefore requested to enable this entity to join the envisaged system.

"The primacy of the position of the Commission's representatives:
"The importance of Lloyd's on the world insurance market no longer needs to be demonstrated. It consists of:
a) an insurance market on which almost any insurable risk can be placed with Lloyd's subscribers through the intermediary of Lloyd's brokers.
b) an association of subscribers who practise insurance operations in the business centre, or exchange, known as Lloyd's.
The purpose of that association is not itself to issue policies but as a legal entity to defend and serve the interests of the subscribers of Lloyd's as a whole.

"At present, 6,500 people are members of Lloyd's, more than a hundred of whom are foreigners.
"A first question arises in the light of this very unusual case: Would it be appropriate to treat it separately, for example by adding a special appendix to the directive? This solution has the major disadvantage of destroying the unity of the directive.
"It seems essential to retain as a basic principle that generally speaking companies must comply with the provisions already decreed by the six member states rather than to introduce "made to measure" components. In these circumstances, the best solution seems to be to try to allow the integration of Lloyd's into the directive by making a minimum of alterations to that directive. With this aim in mind, three problems need to be considered:
- the approval
- the solvency margin
- the presentation of accounts.

"a) The approval
"As Lloyd's is simply an association of subscribers, the problem arises of whether it is appropriate in each member state to require the approval of each subscriber or the approval of the group itself.
"From the point of view of simplicity, it seems clearly preferable to choose the latter solution and consequently to make the required addition to article 8 (i) (a).
"According to the exact wording of article 10 (d), Lloyd's will be represented in each member state where it wishes to do business by a general mandatary whose role will effectively be to represent it to the authorities and jurisdictions of the receiving country. …
…

"b) The solvency margin
"The very principle of this margin, of the guarantee fund and of the methods of calculation, as defined in article 16 of the directive, is an

essential component of the mechanism set up, particularly through the consequences attached to adherence to that margin or fund, as is clear from reading article 20. It is therefore of fundamental importance to find a solution that respects the essential content of article 16.
“Now, where Lloyd's is concerned, the following situation presents itself:

- factual compliance with the obligations of article 16
- adaptation necessary in order to comply with the calculation methods envisaged in article 16.

“Factual compliance with the obligations of article 16

“The solvency of Lloyd's is world renowned and results from the following:

- Each subscriber member is responsible for the whole of his private assets.
- Moreover, each must deposit with Lloyd's a security deposit in cash or approved securities, as a guarantee.
- According to law, each subscriber is individually subject to the obligation to deposit all the premiums he receives for his insurance operations in a trust fund. No profits can be paid to a subscriber on the accounts of any financial year by deduction from his premiums trust fund before the expiry of the second year after the end of the financial year concerned (in fact, 3 financial years).
- Furthermore, it is current practice for subscribers to set up reserves by deduction from the profits made on their insurance operations.
- Since 1927, each subscriber has been obliged to pay an annual contribution to a common fund called the Lloyd's Central Fund the purpose of which is to protect the holders of a Lloyd's policy if it should happen that the guarantees already listed are found to be insufficient.
- Lastly, each Lloyd's subscriber must submit the accounts of his insurance operations, each year, to a very detailed examination by a qualified accountant approved by Lloyd's committee.

“Adaptations necessary to comply with the calculation methods envisaged in article 16

“On the evidence, it seems that although Lloyd's has an adequate financial basis, the solvency guarantees, in their present form, differ appreciably from those required under article 16.
“In particular, Lloyd's accounts based on 3 financial years concern the net commission premiums and not the gross premiums. In these circumstances, Lloyd's should be required to reconstitute these premiums as a lump sum according to a method to be integrated into article 16 at the end of point 2 “first result in relation to premiums”.
“The principles of the directive regarding the calculation conditions of the margin would thus be respected and the present text could be maintained as it is without any other alteration. As regards the assets to be envisaged for constituting the margin, the second sub-paragraph of article 16 can also remain unchanged as the list of the assets taken into consideration is not limiting.

4.2 “Presentation of accounts”

“Because the directive admits Lloyd's as an original entity, it is normal in the framework of the application of article 11 for a solution to be retained which better fits that entity’s accounting possibilities.

“Now, Lloyd's submits to the British authorities not the accounts of the subscribers but overall accounts which give a statistical summary of the extent and characteristics of the insurance operations subscribed by the members of Lloyd's.

“In these circumstances, a solution could consist of introducing into the wording of article 11, paragraph 2, an additional sub-paragraph aimed at envisaging that in the case of Lloyd's the supply of the balance sheet and profit and loss account will be replaced by the transmission of overall accounts.

“Solutions to be envisaged regarding Lloyd's

“Article 8, paragraph 1

“To insert “the association of subscribers called Lloyd's” into the list concerning the United Kingdom.

“Article 16, paragraph 3

“At the end of the paragraph concerning the first result (as regards premiums), to add:

“As regards Lloyd's, the net premiums multiplied by a certain lump-sum percentage are taken into consideration (in order to reach the level of the gross amount), the amount of which is fixed annually and determined by the supervisory authority of the place where the registered office is situated.”

“Article 11, paragraph 2

“To add: “As regards Lloyd's, the transmission of the balance sheet and the profit and loss account is replaced by the obligation of presenting the overall accounts which that association presents to the British authorities.”

4.1.19 Discussion of the draft Directive proceeded during 1973 within the ad hoc Working Party set up by the Permanent Representatives Committee on 10 January 1973.

4.1.20 The note, dated 26 February 1973 (344/73 (E.S. 11)), of what appears to be the first meeting of the ad hoc Working Party which took place on 1 and 2 February 1973 recorded (p5) the following under the heading “the licence” in relation to Lloyd’s:

> “With regard to the legal form of enterprises coming under the Directive, the Working Party suggested that (d) below should be included in the list of forms of enterprises, in Article 8 (1):
>
> “(d) the association of underwriters called Lloyd’s””

The same approach was adopted in the Working Party’s Notes dated 23 March 1973 (pp4-5) and 22 May 1973 (p2) referred to in paragraph 4.1.21 below.

The 26 February 1973 note also included a reaction from the German delegation to the global accounts point to the following effect:

> "The German delegation pointed out that these global statements would be no more than statistical summaries of the extent and features of insurance transactions relating to three consecutive financial years and would not enable the authorities to act in time in the event of a deterioration in the situation."

It therefore suggested that in the amendment to be proposed by the Commission the phrase in square brackets should be replaced by:

> "… which must enable the supervisory authorities to obtain a comparable view of the state of solvency of the association."

4.1.21 An alternative suggested was for an interpretative statement to this effect to be noted in the Minutes of the Council meeting in which the Directive was adopted. That was the suggestion made by the Working Party at its next meeting on 28 February 1973 (see p. 8 of the Note dated 23 March 1973 (609/73 (E.S. 30))) and in the Report (p4) annexed to the Working Party's Note of 22 May 1973 (874/73 (E.S. 49)). A further note dated 4 July 1973 (1392/73 (E.S. 87)) records that, in accordance with instructions received from the Permanent Representatives Committee on 13 June (1287/73 (E.S. 78)), the Working Party met on 28 June 1973 inter alia to insert in the body of the Directive itself the content of the explanatory statements giving details of the application of certain provisions of the Directive to Lloyd's. The proposed insertion for the final sentence of Article 11(2) (at p. 7 of the Note of 4 July 1973) was almost identical to the wording in fact adopted:

> "With regard to Lloyd's the publication of the balance sheet and the profit and loss account shall be replaced by the compulsory presentation of annual trading accounts covering the insurance operations, and accompanied by an affidavit certifying that auditors' certificates have been supplied in respect of each insurer and showing that the responsibilities incurred as a result of these operations are wholly covered by the assets.
>
> These documents must allow the authorities to form a view of the state of solvency of the Association."

4.1.22 As regards the solvency margin required by Article 16, the approach proposed in the Note from the Commission's Services referred to in paragraph 4.1.18 above was considered and proposed in the meetings of the Working Party on 1 and 2 (pp. 7-8 of the Note dated 26 February 1973), 28 February 1973 (p. 7 of the Note of 23 March 1973) and in the Report annexed to the Note of 22 May 1973 (p. 3) which suggested a statement to be included in the Minutes of the Meeting at which the Council adopted the Directive.

4.1.23 Following the instructions received from the Permanent Representatives Committee, a draft addition to Article 16 was then drafted in the form which subsequently became Article 16(5) of the Directive (see p. 7 of the Note of 4 July 1973).

4.1.24 As regards technical reserves in Article 15, the Commission's Note dated 27 December 1972 which considers the position taken by the UK and Ireland on the draft directive a standstill period of four years was requested by the UK on new

rules being introduced on localisation of assets in the fields of marine and aviation insurance. The Commission proposed an amendment in the form of what subsequently became the second sentence of Article 15(2) plus a special provision for marine and aviation insurance.

4.1.25 Any special rule as to localisation of assets was opposed by the Belgian and German delegations (p. 20 of the Note of the Permanent Representatives Committee dated 23 March 1973). It is clear from the Note of the Permanent Representatives Committee of 13 June 1973 (p. 3) that the German opposition was because Member States had been obliged by a previous directive to abolish their guarantee schemes based on the deposit of securities and sureties and to replace them by a system of solvency margins and localised technical reserves. A special rule in this regard would therefore be a step backwards. The Italian delegation noted (p. 5 of the same Note) that at the end of the proposed four year period, there was a risk of total absence of guarantees.

4.1.26 As a result, the Commission withdrew the proposed amendment and the Directive was adopted with express permission for Member States to adopt relaxations to the rule and also allocating responsibility for the relevant regulations to the Member State where the business was carried on (see Article 15(2), second sentence and Article 15(2), third indent).

4.2 **Enactment**

4.2.1 On 24 July 1973 the Council of Ministers of the EEC adopted the Insurance Directive.

4.2.2 The Insurance Directive recited that, with respect to solvency, its aims included the following:-

> “Having regard to the Treaty establishing the European Economic Community, and in particular Article 57 (2) thereof;
>
> “Having regard to the General Programme (1) for the abolition of restrictions on freedom of establishment, and in particular Title IV C thereof;
>
> …
>
> “Whereas by virtue of the General Programme the removal of restrictions on the establishment of agencies and branches is, in the case of the direct insurance business, dependent on the coordination of the conditions for the taking-up and pursuit of this business; whereas such coordination should be effected in the first place in respect of direct insurance other than life assurance;
>
> “Whereas in order to facilitate the taking-up and pursuit of the business of insurance, it is essential to eliminate certain divergencies which exist between national supervisory legislation ; whereas in order to achieve this objective, and at the same time ensure adequate protection for insured and third parties in all the Member States, it is desirable to coordinate, in particular, the provisions relating to the financial guarantees required of insurance undertakings;

…

"Whereas it is necessary to extend supervision in each Member State to all the classes of insurance to which this Directive applies; whereas such supervision is not possible unless the undertaking of such classes of insurance is subject an official authorization; whereas it is therefore necessary to define the conditions for the granting of withdrawal of such authorization' whereas provision must be made for a right to apply to the courts should an authorization be refused or withdrawn;"

…

"Whereas the search for a common method of calculating technical reserves is at present the subject of studies at Community level; whereas it therefore appears to be desirable to reserve the attainment of coordination in this matter, as well as questions relating to the determination of categories of investments and the valuations of assets, for subsequent Directives; (1) OJ No 2, 15.1.1962, p.36/62. (2) OJ No C 27, 28.3.1968, p. 15. (3) OJ No 158, 18.7.1967, p.1."

…

"Whereas it is necessary that insurance undertakings should possess, over and above technical reserves of sufficient amount to meet their underwriting liabilities, a supplementary reserve, to be known as the solvency margin, and represented by free assets, in order to provide against business fluctuations; whereas in order to ensure that the requirements imposed for such purposes are determined according to objective criteria, whereby undertakings of the same size are placed on an equal footing as regards competition, it is desirable to provide that such margin shall be related to the overall volume of business of the undertaking and be determined by reference to two indices of security, one based on premiums and the other on claims;

"Whereas it is desirable to require a minimum guarantee fund related to the size of the risk in the classes undertaken, in order to ensure that undertakings possess adequate resources when they are set up and that in the subsequent course of business the solvency margin shall in no event fall below a minimum of security;

…

"Whereas it is important to guarantee the uniform application of coordinated rules and to provide, in this respect, for close collaboration between the Commission and the Member States in this field;"

5. IMPLEMENTATION OF THE INSURANCE DIRECTIVE

5.1 Obligations imposed on Member States by the Insurance Directive (as successively amended)

5.1.1 The parties will refer at trial to the Insurance Directive for its full terms and effect. The following is a description of the effect of the principal provisions material to the pleaded case, as they evolved following successive amendments.

5.1.2 As regards the obligations imposed by the Directive in its original form, the United Kingdom was obliged to ensure that its laws gave effect to the relevant requirements no later that 27 July 1976 -- "the due date". As regards obligations imposed by way of amendment, each relevant date for compliance is identified below, as is the amending instrument.

5.1.3 The Insurance Directive did not apply to all types of insurance. By article 1 it was expressed to concern "the taking-up and pursuit of the self-employed activity of direct insurance carried on by insurance undertakings which are established in a Member State or which wish to become established there in the classes of insurance defined in the Annex to this Directive". Further limitations on the applicability of the Insurance Directive were set out in articles 2, 3 and 4.

5.1.4 The Insurance Directive, as successively amended, imposed the following obligations on the United Kingdom in respect of direct insurance:

(a) To verify the state of solvency of insurance undertakings whose head offices are situated in the United Kingdom (Article 14; as from 1 July 1994, Article 13). One permitted form of such undertaking was "the association of underwriters known as Lloyd's" (Article 8). The English version of the latter phrase was mistranslated when the Directive was first published, but the error was corrected by a corrigendum published on 7 January 1978;

(b) As regards technical reserves or provisions:-

(i) until 1 July 1994:-

(aa) to require such undertakings to establish "sufficient technical reserves", the amount of which was to be determined according to the rules fixed by the United Kingdom or, in the absence of such rules, according to the established practices in the United Kingdom (Article 15(1)); and

(bb) to verify that each such undertaking's "balance sheet shows in respect of the technical reserves assets equivalent to the underwriting liabilities assumed in all the countries where it undertakes business" (Article 15(4)); and

(ii) thereafter, in the case of annual accounts for financial years beginning on 1 January 1995 or during the calendar year 1995, to require such undertakings to establish "adequate technical provisions", the amount of which was to be determined in accordance with the rules laid down in the 1991 Accounts Directive 91/674/EEC (Article 15(1) as substituted by Art 17 of Directive 92/49/EEC).

(c) To require such undertakings to establish an "adequate" solvency margin in respect of their entire business, "in order to provide against business fluctuations", one third of which (subject to specified minima) was to constitute a guarantee fund (Article 16 and corresponding recitals, and Article 17). Article 16 provided that the solvency margin should be the higher of two "results", each calculated according to the mathematical formulae set out in Article 16, one by reference to the premiums due in the last financial year and one by reference to the average claims paid over the last three financial years. Article 17 also provided minimum levels for the guarantee fund of 400,000, 300,000 or 200,000 units of accounts depending on the categories of risk underwritten; and

(d) To require each such undertaking to produce an annual account covering all types of operation of its financial situation and solvency, and to render periodically the returns, together with statistical documents, necessary for the purposes of supervision (Article 19).

(e) Other requirements were that:

(i) every insurance undertaking shall produce a scheme of operations (Articles 8&9);

(ii) (with effect from 30 June 1990 – Directive 88/357/EEC) that there should be an annual account covering its financial situation, and solvency (Article 19); and

(iii) (with effect from 30 June 1990 – Directive 88/357/EEC) that the competent authorities have the powers and means necessary for supervision of the activities of insurance undertakings established within their territory, including activities engaged in outside their territory, in accordance with the Council Directives governing those activities and for the purpose of seeing that they are implemented: such powers and means to enable the competent authorities to make detailed inquiries, inter alia by gathering information or requiring the submission of documents concerning insurance business, carrying out on-the-spot investigations and taking any measures with regard to the undertaking (or, as from 1 July 1994 -- *per* the 1991 Accounts Directive -- its directors or managers of the persons who control it) which are appropriate and necessary to ensure that its activities remain in accordance with the laws, regulations and administration provisions it has to comply with and to prevent or remove any irregularities prejudicial to the interests of policyholders – where appropriate through judicial channels (Article 19);

(iv) (with effect from 1 July 1994 -- the 1991 Accounts Directive) that the operations be run by persons of good repute and appropriate professional qualifications or experience (Article 8);

(v) (with effect from 1 July 1994 – Directive 92/49/EEC) that there should be sound administrative and accounting procedures and adequate internal control mechanisms (Article 13).

5.2 **<u>The 1991 Accounts Directive and its legislative background</u>**

Travaux préparatoires

5.2.1 Article 54(3) of the EC Treaty provided, at the material time, that "The Council and the Commission shall carry out the duties devolving upon them under the preceding provisions, in particular:-

> "(g) by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 58 with a view to making such safeguards equivalent throughout the Community."

5.2.2 Pursuant to that Article of the EC Treaty the Commission on 21 January 1987 presented to the Council a proposal for a Directive on accounts for undertakings engaged in the insurance sector (OJ 1987 C131/1). This recorded in the first and fourth operative recitals in its preamble:-

> "Whereas Article 54(3)(g) of the Treaty requires the coordination to the extent necessary of the safeguards which, for the protection of the interests of members and others, are required by Member States for companies or firms within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community;"
>
> …
>
> "Whereas such coordination is also urgently required owing to the Community-wide operations of insurance undertakings; whereas, for creditors, debtors, members, policy-holders and their advisers and for the general public, improved comparability of the annual accounts and consolidated accounts of these undertakings is therefore of crucial importance;"

Article 3 of the draft read as follows:

> "1. This Directive shall apply to the association of underwriters known as Lloyd's with such adaptations as are necessary to take account of the particular nature and structure of Lloyd's.
>
> "2. The Commission shall submit to the Council, not later than …, a report on the adaptions made under paragraph 1."

5.2.3 On 23 September 1987 the Economic and Social Committee delivered its Opinion on the Commission's proposal (OJ 1987 C319/13). The Committee's General comments included the following:-

> "1.4 The Committee considers that the present proposed Directive must make it easier to compare published accounts, so that competition between insurance companies can develop."
>
> "1.5 … Accounting rules should have some flexibility, so that the methods of managing insurance business remain different, thus encouraging competition between the different markets. Member States must therefore be allowed a choice to enable the adjustments necessary in the light of market features to be made.

> "But the long-term interests of customers must also be protected and every step must be taken to strengthen the solvency of insurance companies, which is the policyholder's real guarantee."

Dealing with Article 3 the Opinion stated as follows:

> "The Committee would stress the importance of the Directive being applicable to the association of underwriters known as Lloyd's, whose role in the insurance market is vital. It regrets that a definite date has not been laid down for implementing the adaptations necessary.
>
> "In the interests of equal competition, it is essential that comprehensive procedures for applying the Directive to Lloyd's be laid down rapidly.
>
> "The Committee asks that, whatever happens, the date to be included in Article 3(2) must be earlier than the deadline by which the Member States must bring into force the laws, regulations and administrative provisions necessary for them to comply with the Directive, which is to be set out in Article 63(1)."

5.2.4 On 15 March 1989 the European Parliament proposed amendments to the Commission's draft. In the case of Article 3, the Parliament proposed that it should read as follows:

> "For the purposes of this Directive, Lloyd's shall be considered to be an insurance undertaking, although the information relating to the syndicates or members of Lloyd's must meet certain requirements in accordance with the objectives of this Directive".

5.2.5 An Explanatory Memorandum accompanying a note entitled "Draft Council Directive on the Annual Accounts and consolidated accounts of insurance undertakings - Subject: Article 3 – treatment of Lloyd's under the directive. Adaptations as are necessary to take account of the particular nature and structure of Lloyd's" (undated but with manuscript additions dated "15/12" and "23/1") included the following comment in respect of one year accounting:

> "One year accounting would require part of a syndicate's book to operate on a one year basis and part on a three year. Given that Lloyds will retain its current system whereby profits cannot be distributed to Names before the 36 month stage of an account, one year accounting would be both confusing and unnecessary to Names."

5.2.6 As regards reserves, the following comments are made in the same document:

> "At Lloyd's the balance which is closest to a reserve is the so-called "reinsurance to close". The outstanding liability of a year of account is closed by "reinsuring" such liability to a later year of account, in consideration of the payment of a premium equal to the estimated value of known and unknown liabilities.
>
> "Under the Directive Lloyd's would have to show the following: … In respect of reinsurance to close, Lloyd's disclose the following … So, the information which Lloyd's provides in respect of the reinsurance to close is greater than that required by the

Directive, which is restricted to the gross amount and reinsurance amount in respect of outstanding claims. The Directive, on the one hand, does not prevent the disclosure of more information than that set out in the Balance Sheet formats. On the other hand, it appears that the nature of the business at Lloyd's is such that Names should continue to receive the information that they currently do in respect of the reinsurance to close. The Directive should, thus, provide for Lloyd's syndicates to be able to continue to provide this in the current format."

5.2.7 On 24 April 1991, in a Commission Note for Mr Cary, Deputy Chef de Cabinet, the following statement was made (at p. 5) in relation to technical provisions under the proposed Accounts Directive:

> "Although it might at first sight appear to be discriminatory to ask companies to put up technical provisions and not to ask Lloyds to do the same, it will be proposed to the Group not to require technical provisions to be set up in Lloyd's accounts (cf. Annex point 6), the reasons being that under the Lloyd's system technical provisions are neither feasible nor necessary.
>
> As to <u>necessity</u>, it should be noted that solvency cover at Lloyd's differs from other types of insurance undertakings in that
>
> a) solvency at Lloyd's is assessed at the Name level since the Name is the trading entity. An annual solvency test on each Name takes into account estimated loss provisions on open years of account to which the Name is exposed.
> b) this solvency is available across all the numerous syndicates to which a Name might be attached. Therefore surpluses on one syndicate are available to be set off against losses on another.
> c) there is no distribution of profit to proprietors until all liabilities are discharged.
> d) Lloyd's Names do not have limited liability.
> e) liabilities are backed by the total resources of Lloyd's.
>
> As to <u>feasibility</u>, it should be noted that to set up syndicate open year reserves would require a fundamental departure from the existing system:
>
> a) to be meaningful such reserves would not be available to cover deficiencies in other syndicates;
> b) such "dedicated" reserves would undermine and detract from the present insolvency arrangements, whereby individual Names share their capacity between a number of syndicates with the full extent of their wealth supporting all the syndicates with which they are involved."

5.2.8 The same note included the following statements in relation to Lloyd's:-

> "2. In spite of the fact that nor "Lloyd's" as such nor the "Syndicates" working at Lloyd's are undertakings, it was clear from the beginning that Lloyd's had – on competitive grounds – to be taken into account of in the Directive." (p1)

> "1. Lloyd's is not an undertaking, it is a market in which private individuals may write insurance on their own behalf. …" (p2)
> "2. … A Lloyd's syndicate is a one year administrative convenience; it is not an entity with legal powers. …." (p2)
> "2. Insurance groups must, like other groups of undertakings, eliminate intra-group transactions when putting up their consolidated accounts to show their net position against the outside world.
> Lloyd's syndicates are not members of a group since they are in competition with one another and there is no overall authority equivalent to a holding company to guide their business.
> So the question arises, whether Lloyd's should be allowed to disclose only – as they wish – aggregate and thus much higher figures, although their reinsurance transactions between the different syndicates are – as the companies would allege – considerable and accounted for.
> In order to take account of both sides' demands, it will be proposed to the Group that aggregate accounts shall be drawn up by cumulation of the results of all Lloyd's syndicates. They shall contain, however, a note "giving details of all inter-syndicate business including premiums charged and claims paid" (cf. Annex point 2 a)." (p4)
> "[3]a) solvency at Lloyd's is assessed at the Name level since the Name is the trading entity. An annual solvency test on each Name takes into account estimated loss provisions on open years of account to which the Name is exposed." (p5)

The 1991 Accounts Directive as enacted

5.2.9 On 19 December 1991 the Council of Ministers adopted the 1991 Accounts Directive. The 1991 Accounts Directive stipulated that Member States should require insurance and reinsurance undertakings to prepare accounts meeting specified requirements as to form and disclosure, that they be audited, and that they give a true and fair view of each undertaking's assets, liabilities, financial position and profit or loss. The 1991 Accounts Directive was required to be implemented by 1 January 1994.

5.2.10 The recitals to the 1991 Accounts Directive retained the language set out in the proposal as described above, save that the first phrase of the fourth recital now read "Whereas such coordination is also urgently required because insurance undertakings operate across borders;".

5.2.11 The Annex to the 1991 Accounts Directive (which contained an adaptation of the provisions of Directive 78/660/EEC of 25 July 1978 – "the Fourth Directive" -- on the annual accounts of companies) contained provisions applicable to Lloyd's. It stated that "for the purposes of this Directive, both Lloyd's and Lloyd's syndicates shall be deemed to be insurance undertakings". Specifically, it provided that syndicate accounts and Lloyd's aggregate accounts should show:-

(a) for open years, "the excess of the premiums over the claims and expenses paid" (paragraph 6(a));

(b) on the closure of years of account, "provision for claims outstanding", including "provision for … claims incurred but not reported" (paragraphs 6(b) and 8); and

(c) where years were left open, "the amount retained to meet all known and unknown outstanding liabilities, which represents a provision for claims outstanding estimated in the usual manner" (paragraph 9(b)).

5.3 **Relevant laws, regulations and administrative provisions in the United Kingdom in the period 1973 to 1992 and subsequently, with particular reference to insurance business at Lloyd's.**

The Secretary of State and the Defendant

5.3.1 Responsibility for the obligations imposed on the United Kingdom by the Insurance Directive lay with the Secretary of State for Trade and Industry during the period when the breaches of the Directive alleged in the Amended Particulars of Claim occurred. Article 2(1)(c) of the Transfer of Functions (Insurance) Order 1997 transferred the functions of the Secretary of State under the ICA 1982 to the Defendant with effect from 5 January 1998. Article 6(c) of the Order provided that for the purposes of section 2(2) of the European Communities Act 1972 the Defendant was designated (in place of the Secretary of State) in relation to authorisation of the carrying on of insurance business and the regulation of such business and its conduct. Article 5(1) of the same Order provided that:-

> "… all … liabilities to which the Secretary of State for Trade and Industry is … subject at the coming into force of this Order in connection with any function transferred by article 2 of this Order are hereby transferred to the Treasury."

Annual audit and certificate in relation to Names' underwriting

5.3.2 With effect from 28 January 1983, ICA 1982 section 83(4)-(5) replaced ICA 1974 section 73(4)-(5) as the source of the requirement for the accounts of each Lloyd's Name to be audited annually by an accountant approved by the Committee of Lloyd's. The provisions continued to require the auditor to furnish a Statutory Audit Certificate in a prescribed form to both the Committee of Lloyd's and to the Secretary of State (from 24 December 1996, the Defendant). The Certificate continued to be required to state whether in the opinion of the auditor the value of the assets available to meet the underwriter's liabilities in respect of insurance business was correctly shown in the accounts, and whether or not that value was sufficient to meet the liabilities calculated:-

(a) in the case of liabilities in respect of long term business, by an actuary; and

(b) in the case of other liabilities, by the auditor on a basis approved by the Secretary of State (from 24 December 1996, the Defendant).

5.3.3 As at the due date, the form of certificate was that prescribed by the Assurance Companies Rules 1950, r. 16 (see above). With effect from the audit of syndicate accounts as at 31 December 1981, the form of certificate was replaced by that prescribed by the Lloyd's (Audit Certificate) Regulations 1982 (SI 1982/136),

made under ICA 1974. With effect from 22 March 1983, the form of certificate was that prescribed by the Insurance (Lloyd's) Regulations 1983 (SI 1983/224), made under ICA 1982, and from 24 December 1996 by the Insurance (Lloyd's) Regulations 1996 (SI 1996/3011), made under ECA 1972 and ICA 1982….

Basis of computation of liabilities

5.3.4 The basis on which liabilities were required to be calculated continued to be set out in the Audit Instructions. From 1990 these were replaced by the Valuation of Liabilities rules. These instructions and rules were each year approved by the Secretary of State and issued by Lloyd's….

5.3.5 The Audit Instructions, and subsequently the Valuation of Liabilities rules, continued to include instructions as to the quantification of reserves, requiring reserves to be the greater of the following:-

(a) (in relation to most classes of business, including non-marine "all other") the result of the application of a specified multiple to the net premium income for the year of account, known as the minimum percentage reserves ("MPRs"). For the oldest year of account referred to in each year's Instructions, and all years previous to the oldest year of account, an alternative test of outstanding liabilities was to be applied if this would result in higher reserves;

(b) the total of the estimated outstanding liabilities on the relevant accounts as at the relevant date, which was required to include an element to take care of "unnoted and unknown liabilities" (up to 1986) or "liabilities unnoted and incurred but not reported" (from 1987); and

(c) the amount of the RITC for the closing year of account, including any previous years reinsured into that account (provided the year in question was not being run off).

5.3.6 The Audit Instructions provided for a "permitted reinsurance limit" in respect of reinsurance ceded, whereby specified additional reserves were required on reinsurance premiums in excess of that limit. The limit was (leaving aside certain special provisions in relation to motor business) the sum of:-

(a) 20% of gross premium income less brokerage, discount and returns; plus

(b) premiums on all reinsurances effected at Lloyd's; plus

(c) a further 10% of gross premiums less brokerage, discount and returns in respect of reinsurances where reinsurers had agreed to cover their proportion of outstanding losses, either by cash loss reserves established with the syndicates concerned, or by a letter of credit drawn on a bank approved by the Council of Lloyd's.

5.3.7 In the course of considering proposed Audit Instructions, including proposed MPRs, each year the Secretary of State, and subsequently the Defendant, received Settlement Statistics Packages.

Premium trust deed

5.3.8 ICA 1982 section 83(2) replaced ICA 1974 section 73(2) as the source of the obligation on each Name, in accordance with the provisions of a trust deed

approved by the Secretary of State and subsequently by the Defendant, to carry to a trust fund all premiums received by him or on his behalf in respect of any insurance business.

Requirements for Lloyd's as a whole: Statutory Statement of Business ("SSOB") and solvency margin

5.3.9 The Committee of Lloyd's continued to be required to deposit every year with the Secretary of State a "Statutory Statement of Business" in prescribed form summarising the extent and character of the insurance business done by the members of Lloyd's: ICA 1982 section 86, replacing ICA 1974 section 74. Those provisions maintained the stipulation that the Statement for a particular year could not be filed in proper form unless unqualified Statutory Audit Certificates had been received in respect of the insurance business done by each Name participating in one or more syndicates during that year.

5.3.10 By virtue of the following provisions, Lloyd's was in addition required to demonstrate, as part of the Statutory Statement of Business, that it had the solvency margin required by the Directive:-

(a) The Lloyd's (General Business) Regulations 1979 (SI 1979/956), made under ECA 1972 and coming into force on 1 August 1979 applied (with certain modifications) Regulations 4(1) to (3) of the Insurance Companies (Solvency: General Business) Regulations 1977 (SI 1977/1553) to "the members of Lloyd's together" as they applied to an insurance company having its head office in the United Kingdom.

(b) The ICA 1981 inserted into the ICA 1974 new sections 26A, 26B, 26C and 26D relating to margins of solvency and Community margins of solvency of insurance companies. Section 31(1) of the ICA 1981 provided inter alia for sections 26A, 26B and 26D to apply to the members of Lloyd's taken together subject to such modifications as may be prescribed by regulations under the 1974 Act, and to any determination made by the Secretary of State in accordance with such regulations. The Lloyd's (Financial Resources) Regulations 1981 (SI 1981/1655), made under ECA 1972 and ICA 1981 and coming into force on 1 January 1982, applied the solvency margin requirements to Lloyd's subject to certain modifications.

(c) Sections 32 and 33 of the ICA 1982 provided for margins of solvency in relation to insurance companies, and section 84 of the ICA 1982 provided that subject to such modifications as may be prescribed and to any determination made by the Secretary of State in accordance with regulations, sections 32 and 33 applied to the members of Lloyd's taken together as they applied to an insurance company to which Part II of the Act applied and whose head office was in the United Kingdom. The Insurance (Lloyd's) Regulations 1983 (SI 1983/224), made under ICA 1982 and coming into force on 22 March 1983, provided for sections 32 and 33 of the ICA 1982 (and any relevant regulations: the material regulations at the time were the Insurance Companies Regulations 1981) to have effect in relation to the members of Lloyd's taken together, subject to specified modifications.

(d) The Insurance Companies Regulations 1994 (SI 1994/1516), made under ECA 1972 and ICA 1982 and coming into force on 1 July 1994, replaced the Insurance Companies Regulations 1981 and made consequential amendments to the Insurance (Lloyd's) Regulations 1983.

(e) The Insurance (Lloyd's) Regulations 1996 (SI 1996/3011), made under ECA 1972 and ICA 1982, made amendments to ICA 1982 and to the Insurance (Lloyd's) Regulations 1983.

(f) The Insurance (Lloyd's) Regulations 1997 (SI 1997/686), made under the ICA 1982 and coming into force on 1 January 1998, amended the Insurance (Lloyd's) Regulations 1983 as regards the calculation of the solvency margin and the prescribed form of Statutory Statement of Business.

5.3.11 Compliance with the statutory requirements described in the preceding paragraphs was a condition for the exemption of members of Lloyd's from certain of the provisions of the Acts regulating the business of insurance undertakings in general: ICA 1982 sections 15(4) and 83 (replacing ICA 1974 sections 12(4) and 73).

5.3.12 The Secretary of State was empowered to exercise powers of intervention in relation to Lloyd's in the event of failure to maintain solvency margin, or failure to comply with provisions of another Member State's laws giving effect to the Directive or applicable to Lloyd's activities in that State: Lloyd's (General Business) Regulations 1979 (SI 1979/956); ICA 1982 sections 83A and 84(2).

Illustrative timetable

5.3.13 The process broadly followed the same pattern throughout the period from 1979 onwards, and commenced in the summer of the year to which the solvency test was to apply. The following table illustrates the process over the calendar years 1980-1981. It shows the process of audit of syndicate accounts during 1980 and 1981 with a view to closure in Summer 1981 of the 1978 year of account into 1979 as at 31 December 1980 and the preparation of the filing of the SSOB in 1981 reporting the solvency test for the year ended 31 December 1980. Where the practice subsequently materially changed, this is indicated in brackets.

May-July 1980	Provision of settlement statistics to Lloyd's by managing agents.
August 1980	Settlement statistics sent by the Audit Department/MSSD to the DTI -- and by the DTI to the Government Actuary's Department -- and market associations for consideration.
Autumn 1980	Planning by syndicate auditors of the work required for the audit as at 31.12.80 and preliminary check of certain syndicate records and systems.
October/ November 1980	Comments on the settlement statistics received from the DTI and market associations. Recommendations made by the Audit Department/MSSD to the Audit Committee/MSSC as to changes in the prior year's scales of minimum percentage reserves and Audit Instructions, incorporating comments from the DTI and market associations. Recommendations considered by the Audit Committee/MSSC.

October/ November 1980	Meeting with panel auditors to advise them, inter alia, of material changes to the Audit Instructions. (For the 1984 solvency test and thereafter, this meeting moved to December/January).
November/December 1980	Recommendations as to minimum percentage reserves and other changes to the Audit Instructions considered by the Committee. Completion of planning and preliminary work by syndicate auditors.
December 1980	Scales of MPRs approved by the Committee and communicated to underwriting agents and panel auditors, subject to final approval by the DTI. Scales of MPRs sent to and discussed with the DTI/Government Actuaries Department.
December 1980/ January 1981	Syndicate auditors commenced main audit to reach a conclusion on the syndicate accounts and Names' personal accounts.
January/ February 1981	Final approval of Audit Instructions by the DTI. Audit Instructions and Solvency Letter printed and circulated.
March/ April 1981	Review by syndicate auditors of RITC and completion of work required for solvency audit.
end April 1981	Submission of syndicate results for solvency purposes to Lloyd's.
end May 1981	Individual Names' solvency certificates for the year to 31.12.80 completed and provided to Lloyd's and the DTI.
May/June 1981	Approval and signature by managing agent of syndicate accounts as at 31.12.80. Subsequently, signature by syndicate auditors of audit report containing their opinion on the accounts.
Early June 1981	Filing of returns by syndicate auditors (for the 1987 year end, managing agents) required by Lloyd's for the production of the SSOB and Globals.
mid June 1981	Despatch by managing agents of syndicate accounts to direct Names and members' agents. (Prior to the accounts for the year ended 31 December 1983, which were required by Byelaw No. 2 of 1984 to be despatched by 15 June 1984, there was no specific date for despatch of syndicate accounts). Filing of syndicate accounts with Lloyd's (for the year ended 31 December 1983 onwards).
mid July 1981	Despatch by members' agents of syndicate accounts to Names.
End August 1981	Completion and filing of SSOB.
Early September 1981	Publication of Aggregate Results for year ended 31.12.80 (Globals from September 1983 – ie. for the years ended 31.12.82 and subsequently).

Notes:

(i) the sub-division of "All Other" non-marine statistics into three currencies took place in 1981, and it was possible to obtain the historical figures within those currencies;

(ii) from time to time, the categories within which the figures were collected were changed by Lloyd's;

(iii) MPRs were regularly considered by the Audit Committee/MSSC and the Committee;

(iv) concerns were expressed from time to time at meetings of the Audit Committee/MSSC that if the percentages for the US$ "All Other" class of business were set too high, syndicates writing shorter-tail business within that class would be disadvantaged;

(v) Lloyd's made it clear to the DTI, and in the Audit Instructions, that the percentages were absolute minima (The Solvency Letter for the 1984 year end expressly states, at note (i)(a) to clause 6, that: "The scales of minimum percentage reserves represent the absolute minimum requirement for any syndicate."); and

(vi) the settlement statistics were compiled on the basis of net figures.

FSMA 2000

5.3.14 FSMA 2000 brought the regulation of insurance business, including the functions previously exercised by the Defendant in relation to the corporate and Lloyd's sectors, under aegis of the FSA with effect from 1 December 2001.

5.3.15. The FSMA 2000 imposes certain duties and confers certain powers on the FSA in relation to Lloyd's. S. 314(1) and (2) of the FSMA 2000 provide that:

> (1) The Authority must keep itself informed about-
>
> (a) the way in which the Council supervises and regulates the market at Lloyd's; and
>
> (b) the way in which regulated activities are being carried on in that market.
>
> (2) The Authority must keep under review the desirability of exercising –
>
> (a) any of its powers under this Part;
>
> (b) any powers which it has in relation to the Society as a result of section 315."

5.3.16 S.318 of FSMA 2000 confers powers on the FSA to direct the manner in which Lloyd's exercises its powers (i.e. those it has under the Lloyd's Act 1982), as follows:

> (1) The Authority may give a direction under this subsection to the Council or to the Society (acting through the Council) or to both.
>
> (2) A direction under subsection (1) is one given to the body concerned-
>
> (a) in relation to the exercise of its powers generally with a view to achieving, or in support of, a specified objective; or

(b) in relation to the exercise of a specified power which it has, whether in a specified manner or with a view to achieving, or in support of, a specified objective.…

5.3.17 Section 1 of FSMA 2000 provides that the FSA is to have the functions conferred on it by or under FSMA 2000. Section 2 provides inter alia that in discharging its general functions (as defined in section 2(4)) the FSA must, so far as is reasonably possible, act in a way:-

(a) which is compatible with the regulatory objectives; and

(b) which the Authority considers most appropriate for the purpose of meeting those objectives.

The regulatory objectives are defined by s.2(2) to include the protection of consumers (who are defined by s.138(7) of FSMA 2000).

5.3.18 S.5 sets out further guidance on the appropriate degree of protection to be secured for consumers, requiring the FSA to have regard to, inter alia, the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity and the general principle that consumers should take responsibility for their decisions.

5.3.19 Section 22 of the FSMA 2000 provides as follows:-

"(1) An activity is a regulated activity for the purposes of this Act if it is an activity of a specified kind which is carried on by way of business and-

(a) relates to an investment of a specified kind; or

(b) in the case of an activity of a kind which is also specified for the purposes of this paragraph, is carried on in relation to property of any kind.

(2) Schedule 2 makes provision supplementing this section.

(3) Nothing in Schedule 2 limits the powers conferred by subsection (1).

(4) "Investment" includes any asset, right or interest.

(5) "Specified" means specified in an order made by the Treasury."

Paragraph 10 of Schedule 2, Part II, to the FSMA 2000 provides that:-

"The matters with respect to which provision may be made under section 22(1) in respect of investments include, in particular, those described in general terms in this Part of this Schedule."

The investments referred to include, by paragraph 21, the underwriting capacity of a Lloyd's syndicate and a person's membership (or prospective membership) of a Lloyd's syndicate.

5.3.20 Pursuant to Chapter XIII of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544), with effect from 1 December 2001, the following are specified as regulated activities:-

"56. Advising a person to become, or continue or cease to be, a member of a particular Lloyd's syndicate is a specified kind of activity.

57. Managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's is a specified kind of activity.

> **58.** The arranging, by the society incorporated by Lloyd's Act 1871 by the name of Lloyd's, of deals in contracts of insurance written at Lloyd's, is a specified kind of activity."

Being a Name is not so specified.

5.3.21 ICA 1982 was repealed with effect from 1 December 2001 by the Financial Services and Markets (Consequential Amendments and Repeals) Order 2001 (SI 2001/3649). The then extant subordinate legislation made under ICA 1982 lapsed accordingly. Other subordinate legislation referred to above was specifically revoked by that Order. Corresponding provision now appears in rules made and guidance issued by the FSA under FSMA 2000, reproduced from time to time in the FSA Lloyd's Sourcebook.

6. THE LOSSES SUFFERED PRIOR TO THE MARKET SETTLEMENT, THE EVENTS GIVING RISE TO THEM AND SIGNIFICANT COMMUNICATIONS TO NAMES ABOUT THEM

6.1 US casualty claims

6.1.1 The Court of Appeal in its *Jaffray* judgment summarised the position as follows (para. 3):

> "Policies written in the fifties and sixties were coming alive again. Claims were being made in the 1970s and for many years thereafter by persons who suffered from cancer and other diseases caused by inhalation of asbestos during the 1940s and 1950s. Those claims were succeeding against producers and producers were claiming on policies written long before the names ever became members of Lloyd's. Lloyd's syndicates were claiming on reinsurances taken out with other Lloyd's syndicates long before the names became members. Courts in the United States were apparently holding producers liable on any basis that gave the claimant the best prospect of succeeding in his or her claim, and were allowing producers to succeed on claims under their policies on any basis that would lead to insurers or reinsurers having to pay."

6.1.2 Claims by workers against their employers for asbestos-related injury were covered by Lloyd's under third party general liability policies extending to cover product liability and/or employers liability policies. Exposure to asbestos is a causative factor in many diseases, including mesothelioma, lung cancer, gastric cancer and asbestosis. These diseases are typically contracted by workmen who have been exposed to asbestos at their workplace, especially in shipbuilding and the construction, insulation and demolition of buildings of all sorts. Some conditions developed only after prolonged exposure but the most serious (mesothelioma) could result from even a single brief exposure. An important epidemiological study was published in the United States by Dr Selikoff and others in 1964.

6.1.3 Until the advent of asbestos-related claims, such US general liability policies had generally appeared to be reasonably profitable for underwriters at Lloyd's or in the companies market. That changed dramatically with the rapid growth in the manifestation of asbestos-related diseases and changes in tort law in the United States. The first landmark case establishing strict liability was *Borel v Fibreboard* 493 F2d 1076, decided by the Federal Court of Appeals for the Fifth

Circuit in 1973. The *Borel* decision indicated that claims in relation to asbestos-related diseases could be made against product liability policies. But during the 1970s the number of claims was still relatively small and most were settled for modest sums. Rather under 10,000 had been filed in US Federal Courts by 1980. That figure must be compared with about 100,000 claims by the end of the relevant period in 1988 (Lloyd's 1986 year of account) and about 450,000 claims by 2000.

6.1.4 Further important legal developments in the United States were: the decision of the Court of Appeals for the Sixth Circuit in *INA v Forty-Eight Insulations Inc* (5 March 1981, 633 F 2d 1212, cert. denied, 455 U.S. 1009 (March 8, 1982)) upholding the exposure basis of liability; *Eagle-Picher Industries Inc v Liberty Mutual Insurance Company* (14 August 1981, 523 F Suppl. 110) in which the District Court applied the manifestation basis; and *Keene Corporation v INA* (1 October 1981, 513 F Suppl 47, cert. denied, 455 U.S. 1007 (March 8, 1982)) in which the Court of Appeals for the District of Columbia Circuit adopted the so-called 'triple trigger' basis of liability, which was more favourable to claimants than either the simple exposure test or the simple manifestation test. The United States Supreme Court refused petitions in all three cases (an appeal to the Court of Appeals for the First Circuit in *Eagle-Picher* having been largely unsuccessful in June 1982: 682 F.2d 12 (1st Cir. June 30, 1982), cert. denied, 460 U.S. 1028 (March 7, 1983)).

6.2 **Developments in the Lloyd's market in the 1980s and early 1990s**

6.2.1 The number of open years increased steadily during the 1980s, especially for non-marine syndicates subject to asbestos-related liabilities. That appears from the following figures (which would need various qualifying footnotes for complete accuracy, but give the general picture without the need for footnotes):

	number of syndicates	total open years	total open years for non-marine syndicates
1978	17	22	7
1979	26	35	20
1980	23	34	20
1981	25	35	20 (6)
1982	33	41	18 (15)
1983	27	40	21 (28)
1984	58	90	43 (53)
1985	65	110	54 (68)
1986	66	102	58 (70)
1987	65	107	62 (75)
1988	71	119	68 (83)

( ) denotes minimum with known latent liability

6.2.2 According to the report of the Task Force in January 1992, approximately 17,500 Names had at least one open year of account; amongst these 17,500 Names, the average Name had three to four open years of account.

6.2.3 The same trend was reflected in the global results for 1981 to 1985, which can be summarised as follows (with a caveat as to the time-lag before the results were known).

	Overall		General liability	
	Underwriting profit (or loss)	investment income & gains	underwriting loss	investment income & gains
	£000	£000	£000	£000
1981	(43.5)	361.4	(195.6)	111.4
1982	(187.9)	442.0	(425.1)	142.7
1983	(114.7)	416.9	(384.4)	143.6
1984	137.7	432.5	(256.9)	134.9
1985	190.5	373.1	(353.7)	123.8

Thus for each year of account the market as a whole made a profit, after inclusion of investment income and gains, but general liability business produced a substantial loss even after crediting investment income and gains.

6.2.4 In September 1983 Lloyd's presented its global results in a new and clearer form ("the globals") which was used throughout the rest of the relevant period. The globals included a statement by the Chairman and separate reports by the chairmen of specialised associations of underwriters. Mr Cockell, the chairman of LUNMA, referred in rather guarded terms to asbestos-related risks and then commented:-

> “It takes a brave man, or a foolish one, to forecast the outcome of the open years. For what it is worth I would personally expect the bottom line on each to show a deterioration on the preceding one."

6.2.5 In August 1984 the globals for 1983 were published showing an overall profit for 1981 of £ 152m but a pure overall underwriting loss (the first for many years) of about £ 43.5m. Mr Rokeby-Johnson, the chairman of LUNMA, said in his report:-

> "It is rapidly becoming apparent that the potential claims arising from asbestos will dwarf any claim in the history of our industry. It is very sad that in the United States to date under half of the money paid by our industry has ended in the hands of the injured party, the balance is in the capacious coffers of the more rapacious lawyers: for this reason we support, and I very much hope all our industry will support, the concept of a claims handling facility set up by the insurers and manufacturers to look after the interests of the injured."

6.2.6 In September 1985 the globals for 1984 were published. The general (non-marine) liability account showed a pure underwriting loss of £ 425m. In his chairman's statement Mr Miller described this loss as enormous and stated:-

> "Figures such as these make it obvious that underwriters must take stringent remedial action as indeed they are. It is worth repeating that a combination of three things is needed, particularly in the all-important American casualty business; first, a realistic rating level; second, a

reformed policy wording embracing, where needed, a claims-made basis for claims and an overall limit, including legal costs; and third, a measure of tort law reform. Without real progress in all three areas, it is hardly to be wondered at if underwriters increasingly withdraw from this class of business, with the result that certain industries will be left without the insurance coverage which they need to continue in business, to the detriment of society in general."

6.2.7 The globals for 1985, published in September 1986, showed an overall profit for the 1983 year of account of £ 36m (or £ 179m if PCW losses were disregarded). In his Chairman's statement Mr Miller commented that the general liability account generated about 12 per cent of the premium income but 100 per cent of the losses. The pure underwriting loss on general liability business was £ 384m (that is about 10 per cent less than for 1982).

6.2.8 The globals for 1986 disclosed an overall profit for the 1984 year of account of £279m (or £300m excluding PCW) and a pure underwriting profit of £138m. But for general liability business there was a pure underwriting loss of £257m (and an overall loss of £170m). In his Chairman's statement Mr Miller repeated what he had said about the account producing 12 per cent of the premiums and 100 per cent of the losses. He also observed that almost exactly half of the RITC (£2,000m out of £4,000m in round figures) was for general liability claims. Mr Miller stated:-

> "… there is one factor which continues to dominate the whole Lloyd's market and indeed it is perhaps no exaggeration to say it continues to dominate the whole world insurance scene. I refer, of course, to the general liability account. I have in previous years drawn attention to the enormous losses made in this area and I must do so again. The overall loss on this account shows a welcome reduction from last year's figure. However, I have to say that the problems facing those underwriting this account, while perhaps reduced as a result of the reforms in 'the law of tort in the United States, are nevertheless far from solved. Two facts seem to me to stand out; first, that this account produces 12 per cent of Lloyd's premium income and almost 100 per cent of our losses. Second, almost exactly 50 per cent of our reinsurance to close (£ 2,000 million out of £ 4,000 million in round figures) has to be devoted to the claims outstanding within this account; on a premium income base of some £ 400 million any under-reserving must have a sharply disadvantageous effect. In spite of all the efforts that have been made, quite extraordinary court awards and judicial interpretations continue to come from, in particular, the American scène. There are two quite different problems in the whole of this area. First, whether the amounts put aside to meet these claims will be sufficient, a problem of the past which underwriters must do their best to solve. Second, how far it is prudent to commit underwriting resources in the future to a class of business hedged about with such dangers and uncertainties. …"

6.2.9 The globals for 1987 disclosed an overall profit of £211m for the 1985 year of account. General liability business showed an overall loss of £268m and a pure underwriting loss of £354m (of which the Outhwaite syndicates produced about £84m). Mr Lawrence said in his Chairman's statement:

> "The difficulties associated with long tail liability business highlighted by the chairman of the non-Marine Association have resulted in both an underwriting loss and an overall loss. This business is now, however, being written at rates that better reflect the present climate and with policy wordings appropriate to the changed circumstances."

Mr Williams, the chairman of LUNMA said in his statement:

> "Our two main areas of difficulty are in asbestos-related claims and environmental impairment.

6.2.10 The rate of new asbestos-related claims rose steeply, from an average 700 per month in 1985 to 2,000 per month in 1987, due largely to intensive publicity from the plaintiff bar and the seeking out of new industries with an "asbestos connection". There are, however, grounds for future optimism as the rate of increase has declined markedly in recent months." Again, about half of the entire RITC of £4bn was in respect of outstanding liability claims.

6.2.11 In a letter dated 5 October 1988 to MSSD, Mr C W Rome, the chairman of the Lloyd's Underwriters Association, wrote,

> "First I should make it absolutely clear that I make no pretence whatsoever that the reserves my Committee accepted last year, or the alterations we propose now, are correct. All that can be said with certainty is that in no area of their business have Lloyd's Underwriters been so substantially and so consistently under-reserved as in the liability accounts.

6.2.12 The documents which were sent before the end of 1993 by Lloyd's to all Names or to all litigating Names included the following:-

(i) The Global Accounts sent to the Names on an annual basis by Lloyd's.

(ii) The Task Force Report of January 1992.

(iii) The Business Plan of April 1993.

(iv) The Guide to Corporate Capital of September 1993.

(v) The Lloyd's settlement offer of 7th December 1993 with the Kerr Legal Panel Report and the Morse Financial Panel Report.

6.2.13 At the time these documents were sent, a number of Names Action Groups had been or were being formed which were intent on pursuing the Members' Agents and Managing Agents for losses which overlap to some extent with those that are the subject of this suit. Such groups also became involved in litigation between individual Names and Lloyd's. That included Ashmore (see below) and the Central Fund litigation between 1993 and 1995 (in which Names resisted claims by Lloyd's for unpaid losses incurred on their syndicates and covered out of the Central Fund). Subsequently Names were also involved in litigation concerning the terms and enforcement of the 1996 market settlement (see below), including

Jaffray and *Price*. Certain of the litigation involved the making of allegations against Lloyd's for breach of duty notwithstanding the 1982 Act.

6.2.14 By January 1992, proceedings had been brought in the United States Southern District Court of New York against Lloyd's by a significant number of US Names on the basis of Lloyd's misleading representations about investment in Lloyd's Syndicates. Whilst this action was indiscriminately against Lloyd's and various Agents, the allegations were of representations that the Syndicates had adequate reserves for future losses that might arise from asbestos related claims and failure to disclose the insufficiency of reserves and RITCs. [*The Claimants say*: the *Stockwell v. Outhwaite* trial had finished with an agreed settlement of complaints against the Managing Agents for improper writing of run-off contracts without adequate reinsurance whilst cumulating unquantifiable losses. *The Defendant* has no information on this matter, save that claims were made for negligent underwriting and the proceedings were settled in early 1992 by a payment to the Names of £116 million (per Lord Steyn in *Society of Lloyd's v Morris* (HL, 1999).]

6.2.15 In November 1990 the outgoing Chairman, Mr Lawrence, and the incoming Chairman, Mr Coleridge, joined in asking Mr David Rowland to lead a Task Force. Its purpose was "to identify the framework within which the Society should, ideally, be trading in 5-7 years hence ... [with] regard particularly for the long-term competitive position of the Society".

6.2.16 The Task Force made its report ('Lloyd's: A Route Forward') in January 1992. It recommended far-reaching changes including the introduction of limited liability capital alongside the unlimited liability of Names. It also recommended a high-level central stop-loss scheme in order to cap losses for Names with unlimited liability. It recognised what it called 'the old years problem' as one of the gravest threats to the future of the Lloyd's market.

6.2.17 In the course of its deliberations the Task Force (assisted by McKinsey & Co) attempted to quantify the market's ultimate liability for asbestos- and pollution-related claims. It concluded that it would be very difficult to carry out that exercise at a market level, and that the uncertainties were too great to make a reliable estimate simply on an overview. In the event, it took three years of work, and cost more than £100m, to reach an estimate for use as part of the basis for the Reconstruction and Renewal Plan (see below).

6.2.18 After the Task Force's report was sent to Names, several thousand Names attended 54 different presentations in relation to it. It looked at the 3 year accounting system, the one year Syndicate system, the attractions and drawbacks of individual membership and unlimited liability to Names and the organisation of the capital supporting underwriting in order to facilitate effective response to fluctuations in the insurance cycle. It included the following points:-

(i) In the Introduction, at paragraph 1.2, reference was made in particular to past Lloyd's scandals, the losses of the Outhwaite Syndicate, the problem with open syndicates and the rapid deterioration of some business written many years before,

including the rapid growth in asbestosis liabilities arising on Policies long since archived.

(ii) The Executive Summary dealt shortly with the wide range of topics the Report addressed, including Lloyd’s position in the world insurance market, the need for growth, the case for reform of Lloyd’s capital structure, the introduction of high-level central stop loss cover for Names, the strengthening of Names’ rights, additional reserving, the need to increase the accessibility of the Names’ capital in the event of underwriting losses, ways to diversify Names underwriting, ways of adjusting capacity part-way through the year, gaining access to corporate capital including via quota share reinsurance, the desirability of retaining three year accounting, managing old and open years, changes in the agency system, the structure of vehicles for corporate capital, trading syndicate participations, achieving market-wide cost reductions, strengthening distribution channels and reforming the structures of Lloyd’s governance.

Paragraph 28 of the Summary stated that one of the greatest challenges facing the Society was the unknown volume of liability claims arising on US business written over the past 50 years essentially in respect of asbestosis and more recently environmental pollution. Reference was made to the huge range of uncertainty over the scale and timing of the Market's ultimate liability for these potential claims which had led to a sharp increase in the number of open years of account and to the need for Lloyd's to develop explicit reserving guidelines to assist all syndicates to achieve acceptable and consistent standards. Paragraph 30 referred to the ‘old’ and ‘open’ years problems as being particularly intractable.

(iii) The RITC system was explained with the Agent's duty to set it at a level which was equitable to both the re-insuring Names and the Names on the closing year. The Report went on to say (para 6c67):-

> "This approach presupposes that the RITC can be set with a certain degree of precision. In some cases it can, for instance for short-tail business but in many cases it cannot. The RITC can often only reflect a subjective judgement arrived at after considering a wide variety of factors. Consequently the RITC can, with hindsight, often be seen to have been wrong. It will have been set in good faith, drawing on all relevant information and using appropriate reserving techniques, but it can still prove insufficient. Thus the receiving Names must carry a risk that the RITC will prove inadequate (likewise, they have a potential upside should the RITC prove more than adequate). The reality of this risk is emphasised in the 1988 Global Accounts

> which show a deterioration of £356 million in respect of prior closed years, following a deterioration of £195 million in 1987. …"

(iv) Chapter 7 was devoted to the "old years problems" and the "open year problem". These were said to present the gravest threat to the future health of Lloyd's. The uncertainties surrounding old years' claims was so great that many syndicates had been unable to arrive at an equitable RITC after three years and the year had consequently to remain open.

(v) At paragraph 7.8., the Report referred to the size of the old years problem first becoming apparent in the first half of the 1980s with its impact on Names steadily increasing since that point. Over the four years prior to the Report the cumulative prior year underwriting result had been a loss of £1.6 billion, with each year seeing a steady rise. The figures were then set out in a table for 1985 through to 1988.

(vi) The Task Force had attempted to analyse the underlying cause of the prior years' losses to see whether there could be confidence that the Market's current reserves were adequate and that the prior pure year losses would subside from 1989 onwards. In order to test this, they attempted to scale the potential size of the Market's ultimate liability for asbestos and pollution claims and to estimate the Market's current level of reserves for those liabilities. They stated that their analyses were not productive as they were unable to arrive at reliable estimates for some of the critical areas of uncertainty. Nevertheless, the attempts at scaling the problems had to put into sharp focus the enormous uncertainty that still surrounded those liabilities. They said they were unable to develop reliable estimates for several critical uncertainties, most notably, the number of claims still to be reported and Lloyd's share of the liabilities after reinsurance recoveries.

6.2.19 There were several other important inquiries and reports, including the Walker Report (June 1992) into allegations about discrimination against external Names and the operation of the LMX spiral, the Morse Report (June 1992) into the future governance of Lloyd's, and the Open Years Panel Report (March 1993). The Morse Report recommended the replacement of the Committee by two boards, a Regulatory Board and a Market Board, both reporting to the Council. This recommendation was accepted and put into effect at the start of 1995.

6.2.20 During the course of 1992 proceedings were also instituted by Names in Australia alleging fraudulent and negligent misrepresentation by Lloyd's and relying upon representations in the Brochures, sometimes in connection with LMX and sometimes in connection with RITC.

6.2.21 The Annual Report and Global Accounts in mid 1992 made express reference to the need to meet asbestos and pollution claims which had compounded the poor results of the 1989 year and figures were given for the strengthening of reserves in respect of earlier closed years of account and run-off years amounting to

£395.6 million as compared to a comparable figure the previous year of £577.7 million.

6.2.22 In November 1992 Chatset published a guide to syndicate run-offs and commented on serious under-reserving for syndicates with books of US casualty business stating that it was not in question, being found not only at Lloyd's but right throughout the insurance industry. It was said that the problem was serious and that no one could make anything better than an educated guess at the final outcome. Tables were published of the increase in reserves made by the largest 10 syndicates in the years 1987, 1988 and 1989.

6.2.23 In a Lloyd's Names Association Working Party document dated January 1993, reference is made to 25 Action Groups which were "up and running" and to the "asbestos time bomb" which was affecting the Lloyd's Market. The letter makes reference to matters later dealt with in the *Jaffray* trial including the Rokeby-Johnson alleged statement, a meeting of 10th November 1981 of Mr Kiln of the Lloyd's Committee with the Lloyd's Advisory Panel of Auditors about asbestosis, the Neville Russell letter, the closure of the 1979 account despite this and the alleged knowledge of Lloyd's from 1979 onwards of the depth of the problem which it failed to disclose to 19,000 Names who had joined since.

6.2.24 By March 1993, Mr Stockwell of the LNAWP and Chairman of the Panel on Open Years which was appointed to report on the problem to Lloyd's, reported that half of Lloyd's Names were now in law suits against Lloyd's Agents and underwriters, trying to recover damages for what they considered to be the failure of regulation and lack of professional standards. The Open Years Panel identified six major causes for the ever-increasing number of open years. Latent liabilities were the single largest cause, responsible for 42 per cent of open years by number and 60 per cent by stamp capacity. 26,000 Names were exposed to open years with asbestos and pollution liabilities and, as Mr Stockwell wrote to the Chairman of the Market Board in a letter dated 15 March 1993, some 15,000 to 17,000 Names were by then engaged in litigation against Lloyd's agents and underwriters. Reference was made to "unquantifiable and potentially under-reserved liabilities" in the context of RITC and the inability of the Panel to ascertain the full extent of the future liabilities facing the Market and the Names. The Report remarked that, given the widespread nature of the problem, the severity of Names' losses and the inadequacy of Lloyd's responses, it was unsurprising that at least 12 of the actions under preparation were directed squarely at the question of run-offs caused by latent liability and alleged historic under-reserving, with further cases being planned. The Report recommended the formation of NewCo (ie. an entity of the kind eventually established as Equitas – see below) to take over the historic liabilities of syndicates pre- 1985. [*The Claimants say:* the Report was treated as confidential to the Council of Lloyd's and was not circulated to Names. *The Defendant says:* the report was not treated as confidential to the Council, and was made available to all Names to review in the Lloyd's library following its publication in March 1993.]

6.2.25 In April 1993, Lloyd's circulated a Business Plan to all Names because of the "problems of the past". The accompanying letter from the Chairman of Lloyd's pointed out that the current results were the worst in Lloyd's history, that many members had been brought to the brink of financial ruin, that others were fearful

for the future, that confidence in the Society had been shaken and that radical action was required. The alternative was said to be bleak. If the membership and the Market would not unite behind the plan, then Lloyd's itself might have no future. The extent of the crisis was apparent to anyone looking at this document. The plan was to act swiftly to end the uncertainties of open years and old liabilities and to build a new Lloyd's with new independent regulation and higher professional standards, with lower costs and a strong growing capital base. The restructuring which would take place would "ring fence" the problems of the past.

6.2.26 In Chapter 3 of the Report, the plan for managing the old year problems was spelt out, whilst stating that the continuing losses arising on the policies written many years ago were a grave threat to the Society's future. The continual inadequacy of reserving and RITC had led to the need for Lloyd's to propose that "we will develop the systems and controls necessary to improve the objective testing of the adequacy of the reserves for these liabilities" and the reinsurance of the liabilities for 1985 and prior years into a properly capitalised reinsurance company.

6.2.27 The Report also referred to resolution of outstanding legal disputes including claims relating to the continuing increase in long tail liabilities, primarily relating to asbestosis and pollution from business written long before.

6.2.28 The document which proposed the restructuring included the statement that "appropriate professional advice is recommended on any steps any person may propose to take on the basis of this document".

6.2.29 In June 1993, the Association of Lloyd's Members sent out a newsletter referring to the initiation of all but three of the Names' Action Groups and Associations which were reviewed in the letter. The letter listed action groups for 13 long tail Names' groups and the progress they were making in pursuing Managing and Members' Agents. The action against the Janson Green syndicate, Auditors and Members' Agents had already commenced. Details of the allegations to be pursued in other actions were also set out. The document included the following under the heading "Writs Response Group":-

> “"The Group was formed in July 1992 when Lloyd's started issuing writs to Names who had either not paid their losses or had not met solvency as a result of 1988 and 1989 losses. To date, we believe 172 writs have been issued. The Writs Response Group has co-ordinated its defence of those writs and four writs have now been selected by Lloyd's who wish to apply for summary judgement. Therefore all our defences stand or fall with those applications for summary judgment. The importance of these defences cannot be exaggerated. If those cases are lost, we are all open to having our entire fortune plundered by Lloyd's.
>
> Although the subscription is £350, we ask that everyone who may receive a writ to seek as much of that amount as they can afford towards their subscription together with post dated cheques for the balance. These funds are being used to co-ordinate a "master defence" which has taken the best points from the teams of lawyers who represented the original writ recipients.

In addition we are seeking to mount a counterclaim, although to do so one has to be able to show that Lloyd's acted in bad faith. Out of these two approaches has arisen a complaint to the European Commission, under EC Competition Rules. The advantage of that complaint is that Lloyd's has no immunity from suit in respect to it."

6.2.30 The June 1993 Annual Report and Global Accounts included comments about the strengthening of reserves for closed and run-off years of account in relation to asbestos, and the Guide to Corporate Capital showed the figures for deterioration of reserves in earlier years in 1987 – 1990 and referred to litigation against Lloyd's.

7. THE MARKET SETTLEMENT 1993-1996 AND SUBSEQUENT LOSSES

7.1 Description of the R&R/Equitas exercise

7.1.1 In April 1993 Mr Rowland (as Chairman of Lloyd’s, with Mr Peter Middleton as the new Chief Executive) published a document called ‘Planning for Profit: A Business Plan for Lloyd’s of London’. The Business Plan carried forward the Task Force’s proposal for the introduction of corporate, limited liability capital into the market. In addition, it proposed to manage the old years problem by a general scheme for reinsurance of liabilities for 1985 and earlier years through an adequately capitalised reinsurance company. The plan (called the ‘NewCo Project’) eventually came to fruition with the establishment of Equitas as part of the R&R Plan, and with the scope of the scheme expanded to cover liabilities for 1992 and all earlier years. The necessary reserving project was not completed until May 1996. [*The Defendant says* it involved many leading firms of accountants and actuaries.]

7.1.2 In July 1993 the Council appointed an independent Legal Advisory Panel (consisting of Sir Michael Kerr, Mr Stewart Boyd QC and Mr Stephen Tomlinson QC) to investigate and report on 31 specific claims against agents in respect of specified syndicates and years of account. The panel’s report was made in October 1993.

7.1.3 The first Lloyd’s proposal for an overall settlement of the litigation in the market was in the form of a settlement offer document sent to approximately 22,000 Names. This offer was rejected early in 1994. The troubles at Lloyd’s were again becoming a subject of political controversy and more and more cases were coming before the court, either at first instance or on appeal (see further below). (These included 13 judgments given during 1994 (including the House of Lords’ decision [1995] 2 AC 145 in the *Merrett, Feltrim* and *Gooda Walker* cases), 25 in 1995 and 16 in 1996.) Early in 1995 the House of Commons Treasury and Civil Service Select Committee began hearings into regulation at Lloyd’s. In May 1995 it produced a report (‘Financial Services Regulation: Self-Regulation at Lloyd’s of London’) which was critical of Lloyd’s. In particular it stated that those becoming Names from the mid-1980’s were not given full information as to the nature of the risks which they were undertaking. However, the report rejected the so-called conspiracy theory of a dishonest policy of recruitment adopted by the central authorities at Lloyd’s [*The Claimants say*: sometimes known as the “recruit to dilute” allegation].

7.1.4 After the failure of the earlier settlement plan Sir David Rowland put forward a new plan in a document entitled 'Lloyd's: Reconstruction and Renewal' published in May 1995. In the introduction he wrote:-

> "Unless we take radical action now to produce a solution which is acceptable to our policy holders, our regulators, and to you, our membership, I do not believe that the Society will be able to survive in anything like its present form."

7.1.5 The Reconstruction and Renewal ("R&R") scheme involved the following elements:-

(a) Names were offered the opportunity of reinsuring their liabilities (excluding life business) up to the end of the 1992 year of account and of resigning from Lloyd's.

(b) The litigation initiated by Names against Lloyd's and agents was settled through the establishment of a settlement package worth approximately £3.2 bn including debt credits of approximately £2.1 bn.

(c) Some profits on the 1993-95 years of account were released to Names, but reserved to pay their final liability settlements.

(d) Lloyd's agreed to raise some £850m from Names, market professionals and asset disposals, and utilise the Central Fund and the sums payable to Names by E&O policies to fund the package of "debt credits"

7.1.6 The formal R&R settlement offer was sent to Names on 30 July 1996 requiring acceptance by 28 August 1996 (although this time limit was subsequently, extended).

7.1.7 Lloyd's established Equitas Holdings Ltd., owned by a trust, the principal subsidiary of which is Equitas Reinsurance Ltd., which has a wholly owned subsidiary, Equitas Ltd. Both the latter companies were insurance companies under the Insurance Companies Act 1982. In September 1996 Equitas Reinsurance Ltd reinsured the liabilities of Names (excluding life business) up to and including the 1992 year of account, then ceded that business to Equitas Ltd.

7.2 The manner in which R&R may result in, or fail to prevent, subsequent or future loss

7.2.1 Under the terms of the Reinsurance Contract provided for by the Equitas scheme, if the Board of Equitas Reinsurance Limited determines that its Relevant Original Liabilities (as defined) would otherwise exceed its Relevant Available Assets (as defined) [*the Claimants say*: this eventuality is colloquially known, among Names at any rate, as "proportionate insolvency"] then the Board must then decide whether to implement a Proportionate Cover Plan (or, if such a Plan is already in place, to amend the existing Plan) or to pursue normal insolvency procedures (including a scheme of arrangement). If a Proportionate Cover Plan is implemented, then Equitas Reinsurance Limited is entitled to pay claims at a reduced rate. Names reinsured by Equitas remain liable for claims in any event, and in the circumstances outlined above would benefit from reduced reinsurance cover from Equitas to the extent of any reduction in the rate of payment of claims.

8. DOMESTIC LITIGATION IN RELATION TO NAMES' LOSSES AND THE MARKET SETTLEMENTS

8.1 General

8.1.1 Cresswell J delivered his judgment on the Threshold Fraud point in the *Jaffray* action (see below) on 3 November 2000. In Chapter 5 of his judgment the judge referred to the Lloyd's Litigation as "the largest and most complex piece of civil litigation the Commercial Court jurisdiction has ever seen". He explained that the litigation had been divided into the following categories:-

- a. LMX Cases
- b. Long-Tail Cases:-
  - i. Run-Off Contract cases
  - ii. Reinsurance to Close Cases
- c. Personal Stop Loss Cases
- d. Portfolio Selection Cases
- e. Central Fund Litigation
- f. Other Cases.

He went on to explain that the Court had identified preliminary issues and lead or pilot cases for trial as to liability and principles relating to quantum in particular categories.

8.1.2 By way of Appendix 1 to his judgment, Cresswell J itemised some 102 cases within the Lloyd's litigation which had at that date been considered by the Court….

8.2 Litigation against agents

8.2.1 Most of the cases involved claims brought through different Action Groups against members' and managing agents (and sometimes, additionally, auditors) seeking damages for negligence. Occasionally these actions involved an individual Lloyd's Name or a grouping of individuals.

8.2.2 The first major action is that numbered 3 in the list of cases, *Stockwell v. Outhwaite*. The case commenced in October 1991 and settled in January 1992 midway through trial on the basis of a payment to the Claimants. Mr Stockwell was the lead Name. The case was brought with the support of an Action Group.

8.2.3 The other major actions against members'/managing agents were:-

- a. *Arbuthnott & Others v. Feltrim Underwriting Agencies & Others* in January 1996 …
- b. *Henderson & Others v. Merrett Syndicates & Others* in February 1996 …
- c. *Deeny & Others v. Gooda Walker Limited & Others* in March 1996 …

Damages were awarded to the claimants in these cases.

8.2.4 In each of these cases the question was whether the agent had breached duties owned to Names in contract and/or tort in connection with the conduct of the Names' underwriting affairs – in particular negligent acceptance of syndicate run-off business, negligent decision-making in relation to RITC or negligent selection of underwriting business.

8.3 Litigation between Names and Lloyd's

8.3.1 In addition to the Actions against agents, auditors and others, there has been a large volume of litigation involving Lloyd's itself. Almost all the litigation since the 1996 market settlement has involved attempts by non-accepting Names to defend, or establish counterclaims against, Lloyd's claims to enforce liability for the Equitas premium. The most significant elements of the litigation prior to the *Jaffray* judgment are the following…:

Ashmore

In this case Gatehouse J decided that certain terms could not be implied into Lloyd's form of general undertaking (which since 1987 had constituted the contract between the Names and Lloyd's) and therefore Lloyd's did not owe the alleged contractual duties to its Members.

Briggs

The Divisional Court held that Lloyd's was not susceptible to judicial review in the context of calls upon Names for funds.

Clementson/ Mason

The Court of Appeal held that further terms which the Names contended were implied in the contract between Lloyd's and its members were not so implied, but held arguable the Names' case that aspects of Lloyd's arrangements infringed Article 85 of the EC Treaty. On trial of that issue Cresswell J rejected that aspect of the Names' case.

Woodward and *Robinson*

These cases concerned whether Names' litigation proceeds were subject to Lloyd's Premiums Trust Deed (PTD). In *Napier and Ettrick v RF Kershaw Ltd* (1992) Saville J held that the Deed did not cover damages for negligent underwriting. In *Society of Lloyd's v Morris* (1993) the Court of Appeal held that receipts from personal stop loss policies were also not covered. In the meantime a number of other actions had been commenced by other groups of Names. The first action to come to trial was that brought by Names of the Gooda Walker Syndicates. In October 1994 Phillips J found in favour of the Names. Over the following eighteen months or so judgments were also given in favour of Names on several other syndicates. In order to facilitate R&R Lloyds wanted litigation recoveries to be brought within the scope of the PTD. In March 1995 the Council of Lloyd's amended the terms of the PTD by introducing a new clause 2(d) expressly designed to catch litigation recoveries. In May 1996 Sir Richard Scott V-C in *Society of Lloyd's v Woodard* (1996) held inter alia that the 1995 amendments were invalid. An appeal to the Court of Appeal proceeded in tandem with an appeal out of time from *Napier v Kershaw*. The Court of Appeal held in *Napier v Kershaw* that the unamended PTD did catch damages for negligent underwriting. The House of Lords in *Woodward* (renamed *Robinson* after a change of party) held the 1995 amendments to the PTD were valid and that the amended PTD caught damages for negligent underwriting, negligent advice on personal stop loss insurance and negligent advice about syndicate selection.

Leighs and others

The scheme of byelaws, decisions and contracts under which R&R was established and imposed on non-accepting Names was held *intra vires* LA 1982. Orders for summary judgment for the Equitas premium against non-accepting Names upheld. It is for this reason (and because of the decisions in *Fraser* and *Daly)* that the subsequent *Jaffray/Laws* litigation proceeded by way of

counterclaim rather than defence proper. In *Leighs* interim stays pending trial of the counterclaims were refused.

Fraser

The Names were held not to be entitled to raise allegations of bad faith on Lloyd's part as defences to applications for summary judgment for the Equitas premium.

Daly

Foreign securities legislation and other aspects of foreign laws were held not to afford non-accepting Names a defence to claims for payment of the Equitas premium in view of the choice of law/forum selection provisions of the General Undertaking.

8.3.2 Since the date of Cresswell J's *Jaffray* judgment, the following further significant developments have taken place in the Lloyd's litigation:

a. *Society of Lloyd's v. Jaffray*: Cresswell J

The *Jaffray* trial took place in consolidated proceedings involving counterclaims (and in a few cases original claims) by large numbers of Names. The majority were represented through the United Names Organisation (UNO). Names variously made allegations of fraudulent and negligent misrepresentation. The original pleadings in Jaffray included allegations relating to under-reserving for pollution and health hazards as well as asbestosis. The point for trial – the Threshold Fraud issue – concerned the allegation that Lloyd's brochures and globals during the "relevant period" – 1978 to 1988 -- contained fraudulent misrepresentations. The alleged representations focused on the Lloyd's accounting system and the incidence of huge under-reserved liability at the time Names joined. The UNO Names alleged that Lloyd's did not disclose a sufficient picture of the impact of asbestosis losses on the Market "until 1993" and that it was not until then that Lloyd's revealed the matters upon which complaint was based. In his judgment of 3.11.00 Cresswell J dismissed the threshold fraud allegations.

b. *Society of Lloyd's v. Jaffray: Court of Appeal*

The Court of Appeal in *Jaffray* [2002] EWCA Civ 1101 upheld Cresswell J's dismissal of the threshold fraud case, though it held (reversing Cresswell J) that misrepresentations had been made.

c. *Society of Lloyd's v. Laws: Cooke J*

The majority of Names who were party to the *Jaffray* proceedings sought to proceed, by way of amendment or revival of their original pleadings, with counterclaims for negligent misrepresentation. Again, the majority were represented through UNO. Cooke J permitted certain of these cases (in relation to the period prior to entry into force of s. 14 LA 1982) to proceed further but dismissed the remainder, holding amongst other things that the Human Rights Act 1998 did not enable Names to avoid the immunity from suit conferred on Lloyd's by s. 14 ([2003] EWHC 873 (Comm)).

d. *Society of Lloyd's v. Laws: Court of Appeal*

The Court of Appeal dismissed the unsuccessful Names' appeals by judgment of 19 December 2003 ([2003] EWCA Civ 1887).

e. *Society of Lloyd's v Levy: Commercial Court*

Morison J held, inter alia, that (i) the Insurance Directive does not confer rights on Names to complain about a lack of regulation and (ii) it was not arguable that the application of the English 6-year limitation period was improperly stifling a European point.

APPENDIX 2

ABBREVIATIONS

Accounts Directive	Council Directive 91/674: ASF 5.2
ALM	Association of Lloyd's Names
ASF	The Agreed Statement of Facts
Central Fund	A fund to which all Names contributed and to which recourse could be had for specified purposes at the discretion of the Council of Lloyd's
DTI	The Department of Trade and Industry
External Name	Name not professionally involved in the market in the way in which a "working" Name is involved (see below)
The Fisher Report	Report of the Fisher Working Party into Self-Regulation at Lloyd's published in May 1980
FSA	Financial Services Authority
FSMA	The Financial Services and Markets Act, 2000
IBNR	Liabilities that have been incurred but not reported: ASF 2.4.8
(The) ICA 1982	The Insurance Companies Act 1982
(The) Insurance Directive	The First Non-Life Insurance Directive 73/279/EEC
Jaffray	The proceedings entitled The Society of Lloyd's v. Sir William Otho Jaffray Bt. 1996 Folio No 2032
Lloyd's	(depending on context) the Society of Lloyd's or the Lloyd's market
Lloyd's Act or LA 1982	The Lloyd's Act 1982
LNA	Lloyd's Names Association
LNAWP	Lloyd's Names Association Working Party
Long-tail business	Business for which the notification or the settlement of claims, or both, may take many years
NACDE	Names Association for Compensation and Defence in Europe
The Neill Report	Report of the Neill Committee into the Regulatory arrangements at Lloyd's published in January 1987
Open year	a year which is open either (a) in the ordinary course of Lloyd's three-year accounting system (a "naturally" open year) or (b) because a decision has been taken not to close it in the ordinary course (i.e. it is in run-off)
R&R	Lloyd's settlement plan: "Reconstruction and Renewal": ASF Section 7
RITC	reinsurance to close: an agreement pursuant to which underwriting Names of a syndicate for a given year of account (the "closed year") agree with the underwriting Names comprising that or another syndicate for a later year of account that the latter will indemnify the former against all their

	liabilities arising out of the closed year: ASF 2.4.7
RRAPC	The Re-Re-Amended Particulars of Claim dated 9 August 2005
Run-off	A year of account is in run-off if it has been decided not to close it; no new business can be underwritten to a year in run-off
The Second Non-Life Directive	Directive 88/357/EEC
Short-tail business	Business on which claims generally arise and are paid relatively soon after the risk is accepted and the premium paid
Syndicate	annual venture in which underwriting members participate by underwriting business for the year of account in question
The Third Non-Life Directive	Directive 92/49/EEC
TCSC	Treasury and Civil Service Committee
The TCSC Report	Report on "Financial Services Regulation: Self-Regulation at Lloyd's of London"
Underwriting year	Calendar year to which risks underwritten are allocated
UNO	The United Names Organisation: ASF 8.3.2a
Working Name	Name who is substantially involved in the market as an agent, broker or an employee of an agent or broker
Year of account	Same as underwriting year

APPENDIX 3

CHRONOLOGY

Date	**Event**	**Statement of Facts Paragraph(s) (if any)**
25.3.57	Treaty of Rome establishing European Economic Community	
23.12.69	The Cromer Report. Report of a working party on the future of Lloyd's. Made public in 1986/7	
22.1.72	UK Treaty and Act of Accession, Brussels. Effective 1 January 1973	
24.7.73	First Non-Life Directive 73/239/EEC ("the Insurance Directive" or "1NLD") UK obliged to amend national law within 18 months of 27.7.73	4.2 and 5.1
10.9.73	Judgment in *Borel v Fibreboard Paper Products Company, et al,* 493 F 2d 1976. Strict Liability of employer for asbestosis	6.1.3
27.1.75	Date by which UK was obliged to amend national provisions to comply with Directive 73/239	
29.6.76	Council issues Directive 76/580 amending Article 5 of Directive 73/279	
27.7.76	Deadline for entry into force in UK of national provisions to comply with Directive 73/239	
1979	*Keene Corp. v. Insurance Co. of North America*, 667 F.2d 1034 (D.C. Cir. 1981). Established the "triple-trigger" test for determining indemnity responsibility in ongoing damage situations which trigger multiple policies	6.1.4
May 1980	Fisher Report into Self-Regulation at Lloyd's published	
2.7.81	Insurance Companies Act 1981 (c. 31) enacted	5.3.10(b)
1981-2	Outhwaite writes run-off policies. Liabilities of 32 other Lloyd's syndicates consolidated into 317 (Merrett takes more for 417/8)	8.2.2-3
23.2.82	Neville Russell letter	
July 1982	Lloyd's Act 1982	2.2.6
28.10.82	Insurance Companies Act 1982. In force 28.1.83	5.3
10.12.84	Council issues Directive 84/641 amending Directive 73/239, Articles 1, 4, 26, 27	
1985	Outhwaite 1982 year of account left open	
January 1987	Neill Committee of Inquiry Report into the Regulatory arrangements at Lloyd's published. Cromer Working Party report of 23.12.69 made generally available to Names.	
22.6.87	Second Non-Life Directive 88/357/EEC	
30 June 1990	Entry into force of Council Directive 88/357 amending Directive 73/239 Article 19	5.1.4(e)

1991	Lloyd's Task Force set up (Rowland)	
1991	Many more syndicates left open, action groups form.	6.2.23
19.12.91	Directive 91/674/EEC (the "Accounts Directive")	5.2.9 to 11
January 1992	Task Force Report "Lloyd's: A Route Forward" published	6.2.16 to 6.2.18
Jan 1992	Names receive £116m in Outhwaite settlement	6.2.14
18.6.92	Third Non-Life Directive 92/49/EEC. Amends Directive 73/239 Articles 7,8,9,10,13,14,15,15A,18,19,20,22,28.	5.1.4(b)(ii)
June 1992	Morse Report into future governance at Lloyd's published Lloyd's EGM statement	6.2.19
November 1992	Chatsets guide to syndicate runoffs published	6.2.22
1993	First Settlement Offer seeking to settle litigation between Names and agents. Rejected by Names early in 1994	7.1.3
March 1993	The Open Years Panel report	6.2.19; 6.2.24
April 1993	Lloyd's Business Plan published and circulated to Names	6.2.25 to 28 and 7.1.1
16.12.93	Judgment of Saville J in *Society of Lloyd's v Clementson; Society of Lloyd's v Mason*	
February 1994 onwards	Complaints by Names in relation to DTI regulation of Lloyd's	
1.7.94	Entry into force of amendments made by the 1991 Accounts Directive and Directive 92/49	5.1.4
4.10.94	Decision in *Deeny v. Gooda Walker Ltd* [1996] LRLR 183 in favour of Names. Similar decisions reached during 1993-1994 in litigation between Names and other Agencies notably Feltrim, Merrett, Outhwaite, Pulbrook and Bromley	
11.11.94	Decision of Court of Appeal in *Society of Lloyd's v Clementson; Society of Lloyd's v Mason*	8.3.1
December 1994	Treasury and Civil Service Committee ("TCSC") commences enquiry into regulation in Lloyd's (part of wider enquiry into regulation of financial services in the UK) Lloyd's Names Association Working Party (LNAWP) and Association of Lloyd's Names (ALM) Memoranda submitted to TCSC	
May 1995	TCSC publishes report "Financial Services Regulation: Self-Regulation at Lloyd's of London" Lloyd's new settlement plan "Lloyd's: Reconstruction and Renewal" ("R&R") published	7.1.3 7.1.4 to 5
29.6.95	Council issues Directive 95/26 amending Directive 73/239 Article 8.	
July 1995	Government submits response to TCSC on Lloyd's	
22.12.95	DTI publishes its comments on LNAWP discussion paper on alternatives to R&R	
March	Complaints by Names to Parliamentary Ombudsman in	

1996 onwards	relation to DTI's regulation of Lloyd's	
30.7.96	Formal R&R Settlement Offer sent to Names	7.1.6
02.09 96	R&R Settlement concluded and Equitas established	7.1.7
03.09.96	Commencement of 6 year period before Claim Form	
11.9.96	Extended time limit for acceptance of R&R offer	-
30.9.96	R&R premia fall due	
24.9.97	*The Society of Lloyd's v Leighs and Others* [1997] CLC 1398 (CA). Non-accepting Names dispute Equitas liabilities and courts confirm Equitas arrangements	
6.11.97	Petition to European Parliament by Miss Stewart-Smith	
21.11.97	Names serve Points of Defence and Counterclaim in *Jaffray*	
11.2.98	Lloyd's serves Points of Reply and Defence to Counterclaim in *Jaffray*	
3.7.98	Decision of Court of Appeal in *Society of Lloyd's v Fraser*	
8.2.99	Petition to European Parliament by Mr M Anstey and 111 others recorded in Parliament's minutes	
2.8.99	Names serve Amended Defence and Counterclaim in *Jaffray*	
03.09.99	Commencement of 3 year period before Claim Form	
14.6.00	Financial Services and Markets Act 2000: Part XIX relates to Lloyd's	5.3.14 to 21
3.11.00	Decision of Cresswell J in *Jaffray*	8.1.1 and 8.3.2
March 2001	Names Association for Compensation and Defence in Europe (NACDE) sends draft report to European Commission on the application of the Insurance Directive to Lloyd's	-
June 2001	NACDE produces report "The Application of Directive 73/239/EEC to Lloyd's"	
1.12.01	Main provisions of FSA 2000, and the rules and other subordinate legislation by then made under it, come into force.	
21.12.01	First Letter of Formal Notice – Commission to UK Government. Commission commences Infringement Proceedings for failure to implement the Insurance Directive.	
26.7.02	Decision of Court of Appeal in *Jaffray* [2002] EWCA Civ 1107	8.3.2
2.9.02	Claim Form issued in present action	
23.12.02	Claim Form served	
21.01.03	Additional letter of formal notice – Commission to UK Government	

APPENDIX 4

LIST OF PRINCIPAL ISSUES

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1 (**Grant of Rights**) Are the three conditions referred to in the judgment of the Court of Justice in Cases C-6/90 and C-9/90 Francovich [1991] ECR I-5357 satisfied in the present case in relation to the Insurance Directive, viz:

1.1 Does the result prescribed by the Directive entail the grant of rights to persons in the position of the Claimants?

1.2 Is it possible to identify the content of those rights on the basis of the provisions of the Directive?

1.3 Is there a causal link between the breach of the State's obligation and the loss and damage suffered by the injured parties?

2 The first trial is concerned only with the first and second conditions. The Court is invited to assume for this purpose that the Claimants will establish their pleaded case (as amplified by the Particulars of Causation and Loss served on 11 July 2005) on causation.

3 The Claimants assert that the question whether the first and second conditions are satisfied is an issue of law: the question is one of construction of the Insurance Directive read alone or in conjunction with Article 43 EC and/or the 1991 Accounts Directive and is unaffected by the facts of any individual claim. The Defendant says that, while it is primarily an issue of law, it includes factual matters as to the position of the Claimants and the nature and effect of business underwritten by way of reinsurance to close. The issue may be expected to raise essentially the following questions for the Court:

3.1 Are the provisions of the Insurance Directive relating to the system of regulatory supervision for insurance undertakings concerning authorisation, accounting procedures and the verification of the adequacy of their solvency and technical reserves intended, for the reasons given in paragraphs 23 to 28C and 81B to 87 of the Re-Re-Amended Particulars of Claim, to introduce a uniform set of provisions for all Member States to facilitate the exercise of the right of establishment? (It is common ground between the parties that the answer to this question is yes, but the issue is a necessary one which will have to be identified and ruled on by the Court.)

3.2 Do those provisions grant rights to individuals, and if so what rights? (The Claimants submit that they do grant rights to individuals for the reasons given in paragraphs 81B to 87 of the Re-Re-Amended Particulars of Claim. The Defendant does not admit that these provisions grant rights to

insurers (paragraph 4(1)(c) of the Re-Re-Re-Amended Defence), and otherwise denies that those provisions grant rights to individuals or were intended to do so: Re-Re-Re-Amended Defence, paragraph 89. The Defendant's case is that if the Insurance Directive does grant rights to any individuals, it grants to individuals who are direct insurers the right to establish themselves in a host Member State, alternatively in a host Member State and (if there is a sufficient cross-border element) in the Member State of their origin, where they meet the conditions prescribed by the Directive.)

3.3 If those provisions grant rights to individuals, do they grant rights to:

Insurers;

Insured persons;

Insured persons when insured by reinsurance or retrocession; or

Third parties (in whatever sense is contemplated by the second recital to the Insurance Directive);

and, if so, what rights? (The Claimants say that the Insurance Directive grants to them in each of those categories the rights referred to in paragraph 3.5 below. As noted above, the Defendant does not accept that the Insurance Directive granted any rights but, if there was a grant, it was a grant to direct insurers of the right to establish themselves in a host Member State, alternatively in a host Member State and (if there is a sufficient cross-border element) in the Member State of their origin, where they meet the conditions prescribed by the Directive.)

3.4 As regards the grant of rights to insured persons and third parties, these give rise to the following sub-issues:

3.4.1 Are the Claimants "insured persons" in the sense contemplated by the recitals to the Insurance Directive as alleged in paragraph 84A of the Re-Re-Amended Particulars of Claim? Or, by contrast as the Defendant contends, do the Claimants fall outside that term on the ground that any relevant insurance policies from which they benefited were policies of reinsurance or retrocession rather than of direct insurance (Re-Re-Re-Amended Defence paragraph 90A.2.)

3.4.2 What does the term "third parties" mean in the second recital to the Insurance Directive? (The Defendant contends that it means parties, other than the insurer and the insured, who stand to gain from the proceeds of insurance policies, such as injured road users. (The Claimants contend that it includes parties in the position of Lloyd's Names.)

3.4.3 Does the term "third parties" include persons whose relevant interest was in one or more policies of reinsurance or retrocession rather than of direct insurance? (The Defendant contends that it

does not include such persons.) (The Claimants, subject to the reservation that the character of the insurance written goes to the issue of Breach and not Grant of Rights (see below, paragraph 3.6), contend that it does include such persons.)

3.4.4 Are the Claimants "third parties" in the sense contemplated by the second recital to the Insurance Directive as alleged in paragraph 84A of the Re-Re-Amended Particulars of Claim? (The Defendant contends that the answer is no.) (The Claimants contend that the answer is yes).

3.4.5 If and to the extent that the Claimants are "insured persons" and/or "third parties" in the relevant sense, is the Claimants' claim brought in that capacity? (The Defendant contends not, because the Claimants claim *qua* insurers or reinsurers in relation to transactions which they undertook in the market.) (The Claimants contend that the concept of "capacity" is not a relevant one in this context; and that the Defendant's contention in any event wrongly conflates the issues of Grant of Rights and Causation, the better formulation of the issue being that in paragraph 3.5 below. However, if the question is a proper and relevant one, the answer is yes.)

3.5 If those provisions grant rights to persons in the position of the Claimants, what rights do they grant?

(The Claimants say that they grant the right to require of Member States that they shall prescribe and apply the uniform provisions set out in the Directive which are the matters of which complaint is made in the present case. The Claimants also add that issues of the type of loss suffered which are relied upon by the Defendant in this context relate to causation and/or remoteness and not to the grant of rights.)

(The Defendant says that if the Insurance Directive does grant rights, it grants to direct insurers the right to establish themselves in a host Member State, alternatively in a host Member State and (if there is a sufficient cross-border element) in the Member State of their origin, where they meet the conditions prescribed by the Directive. It does not grant to individuals the right to bring a *Francovich/Factortame* claim against a Member State (whether the Member State of their origin or a host Member State) for failure to prescribe and apply the uniform provisions set out in the Directive save when that failure restricts or prevents their freedom of establishment. Accordingly, such right if any as may be granted is irrelevant and/or insufficient because the Claimant's claims (a) do not arise from any infringement of a right of freedom of establishment but from losses the Claimants incurred in transactions undertaken by them as insurers on the insurance market, and/or (b) arise from transactions undertaken by the Claimants qua reinsurers or retrocessionnaires and hence fall outside the scope of the Directive altogether.)

3.6 If the Insurance Directive does grant rights to the Claimants in respect of losses on transactions entered into by them in the course of carrying on insurance business:

3.6.1 Are such rights limited, as the Defendant contends, to that part of the insurance business which comprises direct insurance?

3.6.2 If so, is business arising through the underwriting of reinsurance to close to be treated as direct insurance for the reasons given in paragraphs 2.2.1 and 2.2.2 of the Amended Reply? (The Defendant contends that the answer to this question is no.)

3.6.3 Alternatively, for the reasons given at paragraph 2.2.3 of the Amended Reply is such business to be treated as direct insurance if when the reinsured risk was first underwritten at Lloyd's it constituted direct insurance? (The Defendant contends that the answer to this question is no.)

(The Defendant regards questions 3.6.2 and 3.6.3 as concerning the Grant of Rights issue. The Claimants, however, view them as going to the question whether, if the answer to question 3.6.1 is in the affirmative, there has been a breach in the circumstances of this case, i.e. issue 4; alternatively to the question of causation of loss, issues 6 and 7).

3.7 Alternatively, should the Claimants have a right to seek damages in respect of their claimed losses on the basis that the absence of such a right would put at risk the full effectiveness and/or practical effect of the relevant provisions of the Insurance Directive on the basis of Case C-453/99 *Courage v. Crehan* [2002] QB 507 and as alleged in paragraph 87A of the Re-Re-Amended Particulars of Claim? (The Claimants contend that the answer to this question is yes.) (The Defendant contends that the answer to this question is no.)

3A. (**Identifiable Content**) If and to the extent that the Insurance Directive grants any rights to the Claimants, is it possible to identify the content of those rights on the basis of the provisions of the Insurance Directive? (The Defendant does not accept that the answer to this question is yes.).

4 (**Breach**) Did any breach of the Insurance Directive occur? The parties agree that this is a mixed issue of law and fact. The issue may be expected to raise the following questions (in addition, the Claimants say, to the issue described at para. 3.6):

4.1 For the purposes of the obligations of the United Kingdom under the Insurance Directive as regards the carrying on of insurance business at Lloyd's, is the relevant "undertaking" a Lloyd's syndicate or is it something else?

4.2 To what extent did the relevant provisions of the Insurance Directive give Member States a margin of discretion as to the choice of form and methods which they considered appropriate to achieve the required results?

4.3 Did the Insurance Directive on its proper construction impose on the United Kingdom the obligations alleged in paragraphs 23A and 28A to 28C of the Re-Re-Amended Particulars of Claim and paragraphs 4.1 and 8 of the Amended Reply?

4.4 Did the United Kingdom breach any of the obligations under the Insurance Directive:-

4.4.1 by delegating to Lloyd's part of its obligations as alleged in paragraphs 61 to 69 of the Re-Re-Amended Particulars of Claim and paragraphs 3.3 and 14 of the Amended Reply? Or

4.4.2 (if permission to amend is granted to make the allegations foreshadowed by paragraph 59.1 of the Re-Re-Amended Particulars of Claim) by failing to transpose the provisions of the Insurance Directive into domestic law? or

4.4.3 by reason of the alleged inadequacy of (a) the accounting system of Lloyd's and the setting of reserves at Lloyd's and/or (b) the Defendants' supervision of these matters, as alleged in paragraphs 70 to 80 of the Re-Re-Amended Particulars of Claim and paragraphs 3.2, 5, 8.1, 8.2 and 16-19 of the Amended Reply and/or (c) the Defendant's verification of solvency, as alleged in Paragraph 80A of the Re-Re-Amended Particulars of Claim?

5 (**Seriousness**) Was any breach of the Insurance Directive sufficiently serious to ground liability? It is agreed that this is a mixed issue of law and fact. That issue may be expected to raise the following questions:

5.1 Did the relevant provisions of the Insurance Directive confer a wide measure of discretion to Member States as to the manner in which their objectives were to be achieved, such that liability could arise if at all only if the alleged breach were sufficiently manifest and grave?

5.2 Are the matters alleged in the Re-Re-Amended Particulars of Claim at paragraphs 90.1 to 90.5 (q.v.), 92-93 (nature of Lloyd's), 94 (risk coding and reinsurance), 95 (unlimited liability policies), 96 (accounting and reserving inadequacies), 97-98 (disclaimers of supervisory responsibility) and 98A (failure to transpose, if permission to amend is granted to make the allegations foreshadowed by that paragraph) made out; and, if and to the extent that they are, does it follow that any breach of the Insurance Directive was sufficiently serious to give rise to liability, or by contrast are the circumstances of any breach such that it is not to be regarded as sufficiently serious to give rise to liability?

6 (**Causation**) Is there a sufficient causal link between the alleged breaches of the Insurance Directive and the damage alleged to have been sustained by the Claimants? That is a mixed issue of law and fact, but likely to be primarily one of fact. It may be expected to raise – cumulatively or alternatively – the following questions:

6.1 Which, if any, of the losses alleged to have been suffered by the Claimants have they proven would not have occurred but for the alleged breaches of the Insurance Directive? The Defendant considers that that entails consideration of the following specific matters, but the Claimant disagrees since the Directive is binding as to the result to be achieved, whether or not also requiring a member State to take particular steps to achieve that result:

6.1.1 Bearing in mind the answers to questions 4.1 to 4.3 above, by what method or methods was the United Kingdom entitled to implement the relevant requirements of the Insurance Directive?

6.1.2 If the method in fact used by the United Kingdom was not amongst those methods set out in the answer to 6.1.1 above, what is the minimum extent (if any) to which the use of any of those methods would have resulted in increases in the reserves of the relevant years of account of the relevant syndicates?

6.1.3 Had those reserves been increased to the extent referred to in 6.1.2 above, what (if any) difference would this have made to (i) the extent to which each Claimant participated in subsequent years of account and (ii) the losses which each Claimant has allegedly suffered?

6.2 The Claimants formulate the test of sufficient causal link as follows: did any breach by the United Kingdom of the Insurance Directive materially contribute to the whole or to some part of the losses claimed by each Claimant?

6.3 The Defendant prefers the following formulation:

6.3.1 Were any such losses a sufficiently direct consequence of the alleged breaches of the Insurance Directive?

6.3.2 Were the alleged breaches an effective or dominant cause of the losses alleged?

7 (**Losses**) What losses, if any, has each Claimant proven to have flowed from the alleged breaches of the Insurance Directive? The parties consider that, so far as certain Claimant-specific issues arise on the Claimants' case on limitation, then issue 7 should also include the identification of such, if any, losses as are not time-barred.

8 (**Limitation**) Are any of the Claimants' claims time barred? It is agreed that the applicable limitation period is prima facie that prescribed by s. 2 of the Limitation Act 1980. However, on the Claimants' case (paragraph 7.1 of the Amended Reply) there arise issues as to when that period starts to run and as to whether, even if the period has expired in relation to all or part of the claimed losses, the Claimants are nevertheless entitled to rely on the alternative limitation period prescribed by s. 14A of the 1980 Act directly or by analogy. The Claimants will develop the following case at the first sub-trial:

8.1 As a matter of Community law, on the basis of the Emmott line of jurisprudence, the 6-year period prescribed by the 1980 Act s. 2 does not begin to run until the provisions of the Insurance Directive have been fully and adequately transposed into domestic law (Amended Reply, para. 7.1.2.1). That did not occur until 1 December 2001 (commencement of the FSMA 2000 regime for insurance undertakings at Lloyd's) at the earliest. So these proceedings are in time as regards all the loss claimed.

8.2 If that argument is rejected, then it becomes pertinent to consider when time prima facie began to run for the purpose of domestic law, and to go on to consider whether, on the basis of the Claimants' other arguments, the running of time is nevertheless postponed from that point.

8.3 As regards the prima facie starting point in domestic law, the Claimants have conceded that, unless the running of time is postponed on the basis of the Emmott argument or the other bases set out at paras. 7.1.1 – 7.1.4 of the Amended Reply, their claims for the losses pleaded in the Re-Re-Amended Particulars of Claim stand barred by s. 2 of the 1980 Act , regardless of which of the points described in paragraphs 9(a) and (b) of the Re- Re-Re-Amended Defence is chosen by the court as the point at which their causes of action arose. The Claimants will contend (para. 7.1.5 of the Amended Reply) that neither of those is the correct prima facie starting point. Time did not begin to run until substantial loss was first suffered, and moreover that is the earliest possible moment: the Defendant's breach was repeated or continuing so that subsequent loss suffered in consequence triggered the running of time afresh in respect of that loss. But in any event the Claimants contend on three further grounds -- one of domestic and two of Community law -- that the running of time is postponed beyond the prima facie domestic starting date.

8.4 As a matter of domestic law, the Claimants say (pursuant to para. 7.1.4 of the Amended Reply) that on an ordinary construction of 1980 Act s. 14A, the Francovich cause of action involves fault on the Government's part and should be treated as an "action for damages for negligence". So time does not run against an individual Claimant until he acquired, or ought to have acquired, the necessary knowledge. Thus even if by 2 September 2002 (or such later date on which a Claimant became party to the proceedings) 6 years had expired from accrual of any cause of action, a Claimant may proceed if he did not acquire, and ought not to have acquired, the relevant knowledge until on or after 2 September 1999.

8.5 Alternatively, and again pursuant to Amended Reply para. 7.1.4, as a matter of Community law the principles of equivalence and effectiveness require that the running of time be postponed, by analogy with s. 14A, on comparable terms to those provided by that section.

8.6 If, on either of those bases, a knowledge-based test is engaged as a matter of law, the Claimants will invite the court to find that the Claimants did not acquire, actually or constructively, the necessary knowledge until a point after 2 September 1999.

8.7 The Claimants' final Community point is that to apply the "once and for all" limitation approach to this case would produce a result incompatible with the principle of effectiveness. That principle requires that a separate domestic limitation period start to run in respect of each substantial tranche of loss caused by the continuing failure to implement (Amended Reply, para. 7.1.3). The demands for Equitas premium made by Lloyd's pursuant to the R&R settlement (reached on 3 September 1996) amounted to new and distinct tranches of loss, as would a subsequent or future demand against a Claimant arising under, or out of the failure of, the Equitas scheme. Each triggers a fresh limitation period under 1980 Act s. 2, and the claim is brought in time as regards these losses even if statute-barred in relation to earlier tranches of loss.

9 The Defendant contests each of the bases on which the Claimants contend that the running of time is postponed. It contends that time began to run once and for all against each Claimant at one of the points described in paragraph 9(a) and (b) of the Re-Re-Re-Amended Defence, and each Claimant's entire claim is accordingly statute-barred.

10 The dispute between the parties is predominantly one of law. However, some generic and Claimant-specific factual questions arise. First, the factual background is material to the question whether it is established that the effectiveness of Community law requires a departure from the prima facie position in domestic law. Second, if s. 14A (or a rule akin to it) is found to apply, then it will be necessary to consider what relevant knowledge individual Claimants acquired and when (paragraph 8.6). Third, if the court adopts the approach contended for at paragraph 8.7, then factual questions arise as to what losses were suffered by individual Claimants within the limitation period.

11 It is agreed that, with the exception of (a) the Claimant-specific issue described at paragraph 8.6, (b) any Claimant-specific issues arising under paragraph 8.7 and (c) the matter referred to in the following sentence, all the Limitation issues are capable of determination at the first sub-trial. It is common ground that the question of whether the Insurance Directive was effectively transposed into English law is not a matter for the first sub-trial. The parties consider that the sub-trial of Breach may be a suitable occasion for determining that question. The Claimants will submit, however, that the Defendant should set out its case on that matter so that the Court hearing the first sub-trial is aware of the parties' rival contentions. The issue at paragraph 8.6, if it arises, may be finally determined for the sample Names at the first sub-trial (see paragraph 11 of the CMC Order of 22 February 2005). The parties agree that the manner in which that issue, and any Claimant-specific issue arising under paragraph 8.7, should be managed and determined in relation to the remaining Claimants will depend on the precise terms of the court's findings following the first sub-trial, and can be considered further at that stage. The parties consider that the sub-trial of quantum may be a suitable occasion for determining some or all of those questions.

12 The Claimants will contend that the burden of establishing that all or part of the claims of some or all the Claimants are statute-barred rests with the Defendant.